Financial Organization and Management of Business

CHARLES W. GERSTENBERG, Ph.B., J.D.

FOURTH REVISED EDITION

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RICHARD P. ETTINGER

LOYAL FRIEND
BRILLIANT STUDENT
ABLE TEACHER
CONSUMMATE EXPONENT
OF
INTELLIGENCE IN BUSINESS

Preface to the Fourth Revised Edition

This new edition of *Financial Organization and Management of Business* by Charles W. Gerstenberg presents to the reader the modern methods of organizing a business, financing its permanent and working capital needs, managing its income and surplus, expanding the business through internal growth and combinations, and recapitalizing or reorganizing it as conditions require.

Since the book has been used steadily as the basis of courses in corporation finance for more than thirty years, there has been ample opportunity to discover where changes could be made to help the reader understand the principles more easily. Two new chapters—"Financial Statement Analysis" and "Public Policy"—have been added to this edition. The chapters on working capital have been expanded and those of less importance have been condensed. Otherwise, this Fourth Revised Edition follows the general outline of the previous edition, but it reflects changes in laws, practices, and social thinking that influence corporate financial policy and management. New charts, tables, and examples have been substituted for those outmoded. Thought-provoking problems and research questions replace the old review-type questions.

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CHAPTER 1

The Corporation as a Form of Organization

Scope of book. When a businessman speaks of finance, he may have one of two ideas in mind: he may be thinking of the way money is coined and how funds are created by banks to be exchanged in foreign and domestic banking, or he may be thinking of how individuals and corporations obtain and use funds and distribute the profits derived therefrom. The former idea carries one naturally into the field of banking; the latter into the field of business finance. In this book we shall study the latter idea: how businesses are organized to acquire funds, how they acquire funds, how they use them, and how the profits of the business are distributed. We shall have to consider also what happens to a company when it has insufficient funds or when its operations result in losses.

The relation of finance to other branches of business. Finance is intimately related to the other functions of business, namely, production, marketing, and accounting. When production is inefficient, funds will be wasted, if, indeed, they can be attracted at all by the inefficient concern. The principles of marketing will have to be drawn upon by the financier, first in studying whether to engage funds in a given enterprise, and second, in discovering how to market stocks and bonds. Accounting is intimately connected with finance, for the financial manager must rely upon the accuracy and scientific arrangement of the records of a company to guide him in managing the in-flow and outflow of funds. In this book, therefore, it will be necessary at times to refer to principles of production, marketing, and accounting; but only so much of these subjects will be drawn upon as is essential for the study of finance.

Sequence of discussion. While the first step in finance is the discovery of business opportunities and the subsequent organization of funds, property, and managerial ability into a business concern for the purpose of making profits, this step, known as promotion, presupposes a knowledge of how businesses are organized and financed. For that reason, in this book, the forms of business organization will be treated first. Then the media through which a business finances itself will be explained. By that time the student will be familiar with the principles of financial organization, and an explanation of promotion and the work of the promoter will have greater meaning to him.

Importance of correct selection of legal form of organization. No step in business building and management is more important than that of selecting the legal form of organization. Upon the form of organization depend not only the division of the profits of the business, but the risk run by all those interested in it, the amount of money that can be raised, the placing of control, and many other details incidental to operating a business.

The common forms of organization that are used in the United States and the British Commonwealth are (1) the corporation; (2) the individual proprietorship; (3) the general partnership; (4) the limited partnership; (5) the joint venture; (6) the joint stock company; (7) the Massachusetts trust, or business trust.

In this and the next chapter we shall describe each of these forms of organization, placing greatest emphasis on the corporation because of its importance in American business.

Prevalence of different forms of organization. In 1954 there were about 4,196,700 operating businesses in the United States.[1] If we consider the number of income tax returns filed by corporations [2] for 1953, the latest year for which these figures are available at this time, and partnership [3] returns filed for that year, we can conclude that the prevailing forms of business organization were divided as follows:

Individual proprietorships	82%
Corporations	8%
Partnerships	10%
Total	100%

This table by no means indicates the relative importance of each type of organization. Of greater significance is the percentage of national

[1] *Business Statistics,* 1955 Biennial Edition, U. S. Department of Commerce, Washington, D. C.

[2] *Statistics of Income,* 1953, Corporate Returns, U. S. Treasury Department, Washington, D. C.

[3] *Statistics of Income,* 1953, Partnership Returns, U. S. Treasury Department, Washington, D. C.

business activity conducted by each type of organization. On this basis, the corporation is by far the most important form of organization. Corporations made 82 per cent of the total sales of the country in 1954.[4] The major part of this corporate sales volume, however, is attributable to a comparatively few corporations.

No extended search is necessary to find the reasons for this concentration. In many industries, especially in the manufacture of durable goods, large aggregates of capital are needed to produce goods economically under modern industrial processes. The following tabulation of the number of operating businesses by trades shows that those fields which do not require large amounts of capital to function profitably have the greatest number of enterprises.

TABLE 1. NUMBER OF OPERATING BUSINESSES BY TRADES, JUNE 1954[5]

Operating businesses, total, end of quarter	thous.	4,196.7	*% of Total*
Contract construction	"	441.3	10.5
Manufacturing	"	317.6	7.6
Service industries	"	742.3	17.7
Retail trade	"	1,850.7	44.1
Wholesale trade	"	287.1	6.8
All other	"	557.7	13.3

Laws that govern business. All business, regardless of the form of its organization, is subject to three types of law: (1) common law, (2) statutory law, and (3) administrative law.

The common law is a body of rules laid down by judges in court decisions; it is founded on the customs and prevailing attitudes of the times. Each state has its own common law. Generally speaking, that law is the same among all the states—but there are some variations or exceptions to this rule.

Statutory law comprises the acts of state legislatures or of Congress. We shall see that the law governing corporations is largely statutory, while that governing the simpler types of organization, the proprietorship or the partnership, is largely common law. However, many states have codified their common law concerning partnerships by passing comprehensive statutes on the subject.

The common law is the result of the application of reason and experience in human affairs. But in a highly developed society such as ours the common law frequently proves inadequate. Since it is formed from actual cases or controversies that have arisen between real people, it may fail to fit new situations; it also becomes confused by conflicting decisions that give different interpretations of the same or

[4] Figures obtained by dividing corporate sales for all industries by total business sales. Source: *Business Statistics,* 1955 Edition.

[5] *Business Statistics,* 1955 Edition.

a similar fact situation. For these reasons statutes have been enacted to supersede the common law in many fields; the common law, however, still governs where there is no statute dealing with a specific question.

Out of statutory law has come the third type of law—administrative law. This consists of rules and regulations framed by an administrative body created by a state legislature or by Congress to carry out a specific statute. For example, the Federal income tax law is administered by the Internal Revenue Service. The Service issues regulations and rules that have the weight of law so long as they keep within the scope of the income tax statute. Frequently such regulations interpret in a specific way the legislature's general intent when it enacted the statute. Thus, administrative bodies, which are primarily executive in nature, may also have powers that have the appearance of legislative or judicial authority. No business can afford to overlook what the many state and Federal administrative boards do or say, any more than it can afford to ignore a statute or the common law, where either applies.

The corporation. The corporation is a device for carrying on an enterprise in such a way as to constitute the enterprise itself an entity entirely distinct from the persons who are interested in it and control it. The state authorizes its existence, and as long as it complies with the provisions of the law it continues to exist, irrespective of changes in its membership. It has an individual name by which it may enter into contracts; it may hold property; and it may sue and be sued. It has powers that are given to it by the laws of the state under which it is organized, and powers that it gives itself when it goes through the formalities of organization. It also has the power to do such ordinary things as are necessary in the conduct of its business. A further description of the powers of a corporation is given at page 15. The owners of the enterprise are called stockholders.

Kinds of corporations. Although this book deals exclusively with business corporations, these are not the only kind of corporations that may be organized. Basically, there are three kinds of corporations: public corporations, non-stock corporations, and business corporations.

Public corporations include all the subdivisions of a state, such as cities, villages, tax districts, irrigation districts, and the like. They also include government-owned corporations which are organized by Congressional authority as agencies of the United States Government. Examples are the Commodity Credit Corporation and the Federal Deposit Insurance Corporation. A study of the financial operations of public corporations is entirely beyond the purview of this book.

Non-stock corporations include, besides some of the public corporations, such membership corporations as unincorporated clubs, fra-

ternities, museums, and religious, educational, and charitable institutions. Usually special laws are passed to regulate the management of these various non-stock corporations.

Business corporations are stock corporations carrying on an enterprise for profit. Those engaged in ordinary manufacturing or mercantile pursuits are known as *private corporations.* They are the simplest to organize and manage and are usually freer from governmental control than are other kinds of business corporations.

Banks and insurance corporations are known as *moneyed corporations.* Although they are business corporations, they are usually organized under special banking and insurance laws and are subject to close supervision by banking and insurance departments. In this group would also come investment companies in those states in which such companies are subject to special control.

Business corporations that furnish utility services to the public are known as *public service corporations.* They are sometimes called "quasi-public corporations," or more simply, "public utilities." They include the railroad, gas, electric light and power companies, electric railway and bus lines, telephone, wire-telegraph and radio-telegraph carriers, hydro-electric, water, and in some cases, irrigation and other corporations. Their common feature is a special franchise to use public property for private use, though in some few cases all the property is owned by the company. They are now generally under the control of public service commissions that regulate not only the ordinary operations of the company, but prescribe uniform systems of accounting and pass upon proposed security issues. Public utilities will be referred to from time to time in this book, but their special features as public service corporations will not be treated.

Business corporations are also differentiated as domestic, foreign, and alien. Companies are designated *domestic* in the state in which they are incorporated; *foreign* in other states of the United States in which they "do business"; and *alien* if they are organized in other lands.

Special mention must be made here of the doctrine of interstate commerce to clarify the regulation of foreign corporations. When the states formed the Union, they gave to Congress the power to regulate interstate commerce. With a few minor exceptions, this power is now held to be committed exclusively to Congress, and the states are not permitted to interfere.[6] If, therefore, a corporation does business from its home state *into* other states—for example, by sending a salesman through it to take orders to be filled by shipments from the home state

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[6] Southern Pacific Co. v. Arizona, (1945) 325 U. S. 761, 65 S. Ct. 1515, is a leading case on this point. See also page 361, note 26.

—those states will not be permitted to exclude the corporation on any terms. This rule results from the state's inability to interfere with the right of Congress to regulate interstate commerce. But if the corporation attempts to "do business" *inside* the state—for example, by establishing a local branch there—it will to that extent be engaged in *intra-* as distinguished from *inter*-state business, and the state may require the corporation to qualify as a foreign corporation. We shall see later what qualifying consists of (page 37, note 2).

The legal-entity concept. The legal concept that a corporation is a separate entity distinct from the natural persons who compose it gives the corporation its great advantage as a form of business organization. The legal-entity concept must, therefore, be clearly grasped if the student is to understand the real nature of the corporation. The classical definition of a corporation given by Chief Justice Marshall in the famous Dartmouth College case, which, incidentally, did not involve a business corporation, will help the student toward this end.

> A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law. Being the mere creature of law, it possesses only those properties which the charter of its creation confers upon it, either expressly or as incidental to its very existence. These are such as are supposed best calculated to effect the object for which it was created. Among the most important are immortality, and if the expression may be allowed, individuality, properties by which a perpetual succession of many persons are considered as the same, and may act as a single individual. They enable a corporation to manage its own affairs, and to hold property without the perplexing intricacies, the hazardous and endless necessity of perpetual conveyances for the purpose of transmitting it from hand to hand. It is chiefly for the purpose of clothing bodies of men in succession with these qualities and capacities that corporations were invented, and are in use. By these means, a perpetual succession of individuals are capable of acting for the promotion of the particular object, like one immortal thing. [Dartmouth College v. Woodward, (1819) 4 Wheaton 636.]

The definition brings out two points to remember in thinking of the corporation as a legal entity: (1) The corporation exists only in contemplation of law. In other words, without a law to give it life, a corporation could not exist. From the discussion of how a corporation is organized, which will appear later, the student will see the corporation as a creature of the law. (2) The corporation is a legal personality, and as such is capable of acting in many respects as a single individual. However, since it is not an individual, it enjoys certain immunities that natural persons do not. For example, it cannot commit treason. Also, since it is an artificial being, or person, created by law, it can act only through its members as a body or through the directors and officers who direct its affairs.

The reader may immediately raise the question of whether or not the corporation offers an opportunity to unscrupulous people to hide behind the cloak of the legal-entity concept and use the corporation to do things which they as individuals cannot do, or to shift the responsibility for their own acts to the separate entity. That they may try to do so is clear from the multitudinous cases that have come before the courts involving this point. The courts do not adhere strictly to the fiction of separate existence of the corporation. They have disregarded the separate entity when recognition of it would sanction a fraud or promote an injustice, and have refused to disregard it when to do so would result in inequities. Each case is considered on its own facts. The courts have disregarded the corporate entity when it has been used as a device to violate or evade the law. Some legislatures have tended to protect the public against abuses of the legal-entity concept by making those who are responsible for the conduct of the corporate affairs liable as individuals for illegal acts of the corporation. However, the states have moved cautiously with this type of law-making for they do not want to discourage the organization of corporations under their respective laws.

A leading case will help to bring out the importance of recognizing the corporation as an entity separate from the natural persons involved. A corporation sold its property, business and goodwill, agreeing with the purchaser not to engage again in business in competition with the corporation. A stockholder, who was also an officer in the selling corporation, subsequently organized a corporation in the same line of business. The purchaser contended that the contract bound the stockholders and officers of the selling corporation as well as the corporation. The court, however, held that the contract was with the corporation only and not with its stockholders and officers.[7]

Another case illustrates the effect of casting aside the legal fiction of corporate existence and dealing with the corporation and its owners as identical entities with identical duties and obligations. A brewing corporation changed its structure to a partnership with the same name. The stockholders and officers became partners holding the same proportionate interest in the partnership as they had in the corporation. The corporation was not dissolved, but remained in existence to collect debts owed it, continuing for a short time to use the offices of its successor. No changes were made in the labels, packing cases, letterheads or invoices. An individual sued the corporation for damages for personal injuries resulting from the explosion of a bottle of beer. The corporation denied liability, contending that the beer was bottled by

[7] Hall's Safe Co. v. Herring-Hall-Marvin Safe Co., (1906) 146 F. 37 [modified on other grounds, (1908) 208 U. S. 554, 28 S. Ct. 350].

the partnership and not by it. The court refused to recognize two separate entities to prevent the working of an injustice. The individual won his suit.[8]

Fundamental corporate characteristics. The corporation has certain fundamental characteristics that have made it the most popular form of business organization. These are: (1) transferability of shares; (2) continuous succession; and (3) limited liability. The student will observe, in the explanation of these corporate features, how they tie in with the legal-entity concept and will see why we mentioned earlier that this concept is at the root of the advantages of the corporate form of organization.

Transferability of shares. We have already seen that the individuals who compose the corporation are not the corporation—they are merely the owners of it. The ownership of the corporation is represented by its capital stock, which is divided into identical units or groups of identical units called shares. These shares are represented by written instruments called certificates of stock. Hence the name "stockholders" for the owners. Every stockholder has the right to transfer his shares of stock—a right based upon the inherent power of a person to dispose of his property. The transfer of stock from one owner to another has no effect whatever upon the corporation as a legal entity. As we shall see in the following chapter, this characteristic of corporate enterprise is in marked contrast with the effect of a transfer of an interest in a business conducted as an individual proprietorship or a partnership. Here it is sufficient to say that when an individual sells his business, the enterprise may or may not continue in existence; when a partner in a general partnership sells his interest in the business, the enterprise is dissolved.

Transferability is not always as easy as it sounds. In instances where the ownership of a corporation is closely held by a few people it may be difficult to find a purchaser of the shares who will pay a fair price for them. Indeed, sales of shares in close corporations at the death of a principal owner must frequently be made at great sacrifices. On the other hand, where the stock of a corporation is widely held and the shares are listed on an organized stock exchange, finding a purchaser is no trouble at all.

The easier it is for a person to come into and depart from a corporation, the more likely he is to be an indifferent stockholder. That is why stockholders in large corporations are, on the whole, an apathetic group. The stockholder generally does nothing as long as he is satisfied with the income he is getting from the investment he has made in his shares. When he becomes dissatisfied, he sells his shares. We shall

[8] Gordon v. Aztec Brewing Co., (1949) 23 Cal. (2d) 514, 203 P. (2d) 522.

see later that the stockholders can do something other than sell their shares when they become dissatisfied with the way the corporation is being managed.

Continuous succession. Since the shares of stock of a corporation may be transferred by sale or otherwise from one owner to another without affecting the corporate existence, the corporation enjoys continuous succession. The existence of the corporation is not disturbed by the death, insanity, or bankruptcy of individual stockholders or by the change of ownership. Practically, of course, it may be disrupted by a change in management that follows a change in ownership, just as it may be disrupted by any other turn of events that makes it unwise to continue the venture. But we are talking here about existence as an element of the corporate form of organization.

When the corporation is organized, it must usually state in the incorporating papers that are required to be filed the period for which the corporation is to exist. In most states, the corporation may either indicate that it is to have perpetual existence or state a limited period of duration. In some states—Arizona, for example—a definite period of existence must be stated in the articles of incorporation, not to exceed the maximum duration set by the statute. In such instances, the statutes usually contain provision for extension of the corporate existence for an additional period by compliance with certain prescribed preliminaries. In any case, the renewal of the corporate existence at the expiration of a stated duration period is a simple matter.

Limited liability. When people invest in a business, especially a new one, they know that there is always the possibility that the business will not succeed and that the company may find itself unable to meet its obligations to creditors. The creditors of the business look first to the assets of the firm for payment of debts due them. If the assets are insufficient to satisfy all their claims, the question of personal liability of the owners arises. In determining the liability of the owners of the business for unpaid debts, the form of business organization is extremely important. In a corporation, the liability of the stockholders is limited as follows: the owner of *fully paid* stock ordinarily has no liability to creditors; the owner of stock that has not been paid in full is liable, in case of the insolvency of the corporation, to pay, as far as is necessary to satisfy creditors, the amount required to make his stock fully paid. What constitutes fully paid stock will be discussed in Chapter 5, where corporate stock is described in detail.

Assurance of limited liability is the most favorable aspect of the corporate form of organization from an investor's viewpoint, for the stockholder can determine at the outset the limit of loss on his investment. If he purchases a share of fully paid stock directly from the corporation or from any stockholder, the most he can lose is what the

stock cost him because he has no liability to creditors. Thus, if *A* buys a share of stock having a par value of $100 and pays the corporation $100 for it, and later sells the stock to *B* for $25, *B* will have no liability to creditors and the most he can lose is his investment of $25. If *A* had paid only $60 to the corporation for a $100 par value share, and then sold the stock to *B*, *B* would be liable to creditors up to $40, regardless of what he paid for the stock. The most he could lose, therefore, would be what he paid for the stock plus $40 that might have to be paid to creditors. Generally, corporations do not issue stock certificates to shareholders until they are fully paid, and a purchaser of stock from another shareholder is usually safe in assuming that the stock certificate he receives is fully paid for.

The laws of the several states cover the subject of stockholders' liability and the conditions under which the liability arises. They must be examined to see whether there are any exceptions to the ordinary limitations upon stockholders' liability. One exception is a possible liability for wages and salaries due to mechanics, workers, laborers, or servants employed by the corporation. This provision is found in a number of states. Another possible exception arises in the case of state-chartered banks. Before 1933 many of the state laws imposed double liability upon owners of bank stock; that is, each bank shareholder was liable up to 100 per cent of the par value of his stockholdings in addition to the amount invested. Double liability was practically abolished for national banks by the Banking Acts of 1933 and 1935. Since then most of the states have eliminated the double liability provision from their banking laws.

To indicate that the organization is a corporation with limited liability of stockholders, the corporation laws require that the name of the company include the word "Corporation" or "Inc." In a few states, the British form, "Limited" or the abbreviation "Ltd." following the name of the corporation, may be used. This requirement is a protection to creditors.

How corporations are organized. At one time corporations were organized by the enactment of a bill in the legislature that read in effect, "Be it enacted by the people of the State of ———, by legislature in Senate and Assembly represented, that (here followed the names of the interested persons) be and they hereby are constituted a body corporate under the name of (here the corporation name) for the purpose of (and here followed the objects of the corporation)." Then were added other provisions regulating the company and giving it certain powers, such as the power to pass by-laws, issue stock, and so on. When the bill was passed by both houses and signed by the governor, the incorporators met and "accepted" the charter contained in

the act of the legislature, accepted subscriptions, and issued stock, and the corporation was complete. This was called incorporation by special act of the legislature. The method is rarely used nowadays.

A new and simpler method of incorporating has been devised. The state passes a general law providing that any group of persons executing the proper papers and filing them in the proper offices, at the same time paying the proper fees, thereupon shall create the corporation. The statutes have been made very complete in respect to the details of organization and management and in respect to the rights and liabilities of the various persons interested.

The laws, however, vary from state to state. Also, they have been subject to interpretation by the courts. Even where two or more states have a similar provision, that provision may mean one thing in one state and something different in another. As a result, it is not safe to state dogmatically what the rules are under which all corporations function. However, certain principles have become well established through long lines of decisions at common law and recognition of them in the corporation codes. It is thus possible to give the student a general understanding of the corporation as a form of organization without constantly reminding him that it is a legal entity subject to the limitations laid down by the law which gave it existence.

State of incorporation. Since the statutes vary from state to state, the promoters of the corporation should be very careful in incorporating a company to select a state where the laws are not unfavorable. In some states the laws are more favorable than others, from the standpoint of the corporate managers. Thus, the corporation laws of one state may grant the corporation and its board of directors powers that are not granted by the laws of other states, and may offer the stockholders less rights and protection than other states do. Delaware, for example, is the most popular incorporating state because it is most liberal from the standpoint of the corporation managers. Taxation is another important aspect of corporate life that is affected by the choice of a favorable state. Taxation, it must be remembered, includes all these state taxes: the original organization tax; the annual franchise tax; the stock transfer tax, which now exists in Florida, Indiana, New York, South Carolina, and Texas; the ordinary property taxes; business license taxes; sales and use taxes.

For some idea of the variability of the statutes on the essential points to be considered in choosing a state of incorporation, see Appendix A. The statutes of the states in which at present most corporations are organized have been selected for comparison.

Only one basic rule can be given as a guide in the selection of a state of incorporation: other things being equal, a corporation should

incorporate in the state where it is to carry on its principal business. Once the state of incorporation is selected, the formality of organizing is begun. A typical incorporating procedure is described below.

Example of incorporation in New York. Suppose Joseph Hall, James McKeon, and Andrew J. Cook wish to form a company in New York with a capital stock of $100,000, for the purpose of manufacturing and dealing in certain automobile accessories.

First they would draw up a certificate of incorporation under the Stock Corporation Law of the State of New York. In its simplest form, this certificate would read as follows:

CERTIFICATE OF INCORPORATION
OF THE
HAMILTON AUTOMOBILE CO., INC.

(Pursuant to Article Two of the Stock Corporation Law)

We, the undersigned, for the purpose of forming a corporation pursuant to Article Two of the Stock Corporation Law of the State of New York, certify:

First: The name of the proposed corporation shall be Hamilton Automobile Co., Inc.

Second: The purposes for which it is to be formed are to make and deal in automobiles, automobile accessories and supplies, and supplies for whatever purpose used. (Note: usually this clause is expressed at greater length and the corporation is given a wider range of "express" powers.) [9]

Third: The amount of the capital stock of the corporation shall be $100,-000.

Fourth: The capital stock shall consist of 1,000 shares of a par value of $100 each, all of which are to be of the same class.[10]

Fifth: The principal office of the corporation shall be located in the City, County, and State of New York and the address to which the Secretary of State shall mail a copy of any process in any action or proceeding against the corporation, which may be served upon him, is 70 Fifth Avenue, New York, N. Y.

Sixth: The duration of the corporation shall be perpetual.

Seventh: The number of directors shall be not less than three nor more than seven.

Eighth: The names and post-office addresses of the directors until the first annual meeting of the stockholders are:

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[9] The student who is interested in seeing the actual wording of clauses granting express powers will find an exhaustive compilation of them in *Encyclopedia of Incorporating Forms* (Englewood Cliffs, N. J.: Prentice-Hall, Inc., 1948).

[10] If the stock is to be divided into various classes, this paragraph will contain the descriptions of the classes. For specimen clauses, see *Encyclopedia of Incorporating Forms*, cited in note 9.

Name	*Post-office Address*
Joseph Hall	98 South Elm Ave., Brooklyn, New York City
James McKeon	108 North Oak Ave., Bronx, New York City
Andrew J. Cook	118 West Poplar Rd., Queens, New York City

Ninth: The names and post-office addresses of the subscribers to the certificate, and the number of shares of stock which each agrees to take are as follows:

Subscriber	*Post-office Address*	*Shares*
Joseph Hall	98 South Elm Ave., Brooklyn, New York City	50
James McKeon	108 North Oak Ave., Bronx, New York City	2
Andrew J. Cook	118 West Poplar Road, Queens, New York City	2

Tenth: All the subscribers to this certificate are of full age, at least two-thirds of them are citizens of the United States, at least one of them is a resident of the State of New York, and at least one of the persons named as a director is a citizen of the United States and a resident of the State of New York.

Eleventh: The Secretary of State is hereby designated as the agent of the corporation upon whom process in any action or proceeding against it may be served.

In witness whereof we have made, signed, and acknowledged this certificate on the 9th day of November, 19...

(Signed) JOSEPH HALL
JAMES MCKEON
ANDREW J. COOK

The certificate of incorporation often contains matters governing the internal arrangements of the corporation that the incorporators wish to be stable. Such provisions, often referred to as regulating clauses, cover methods of electing directors and officers, compensation of directors and officers, contracts with interested directors, and the like. These clauses usually appear before the paragraph marked *Eleventh* in the above certificate of incorporation.

The certificate is acknowledged before a notary and the original is sent to the Secretary of State at Albany, New York, accompanied by a certified check covering the standard filing fee of $40 and the organization tax which is computed at the rate of $.50 per $1,000 of par value shares authorized. In this case, the tax would be $50.[11] If the Secretary of State finds that the certificate conforms to the law, does not contain any prohibited powers, such as railroading, engineering, and insurance, and the name is acceptable, he will file the certificate

[11] If the shares were without par value, the tax would be the same since the rate is $.05 per share of no-par stock.

and notify the person who sent it. The Secretary of State makes a photostatic copy of the certificate, affixes his certification thereto, and transmits this copy to the clerk of the county where the corporation's principal office is located, for filing.[12] Corporate existence commences immediately upon the filing of the certificate of incorporation with the Secretary of State.[13] However, prior to the commencement of business, directors hold their organization meeting. At the directors' meeting, the by-laws and corporate seal are adopted, officers are elected, a bank is selected, offers to buy the corporation's stock are considered and accepted or rejected, and any other matters properly relating to the organization of the company are considered and passed upon.

The certificate of incorporation of a company, together with the corporation laws governing its existence, is the corporation's charter. These documents are accessible to the public. Therefore, everybody who deals with the corporation is assumed to have notice of their contents and will be bound by them.

By-laws. Ordinary matters of internal management are placed in the by-laws, which contain the rules binding on directors and stockholders. We cannot afford the space to give a set of by-laws in full, but a reasonable understanding of the way in which corporations conduct their internal management will not be had unless we give a digest of a short form of by-laws.[14]

The by-laws frequently repeat provisions contained in the certificate of incorporation, though this repetition is unnecessary. If a conflict should appear between the two documents, the certificate would govern. Of course mistakes may be corrected if the corrections do not prejudice the interests of innocent stockholders. One of the subjects often duplicated is the rights of stockholders, especially with regard to dividends. Indeed, these provisions of the contract between the corporation and the stockholder are usually repeated even in a third place —the certificates of stock. These provisions we shall take up later.

The by-laws also usually contain rules governing the issue and transfer of stock, or empower the directors to make such rules. The by-laws set the time and place of the annual stockholders' meeting, provide for methods of calling special meetings, and stipulate the number necessary to be present to constitute a quorum. Similar provisions are made for the directors' meetings. If there are any standing commit-

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[12] In New York State, if a corporation wishes to have a certified copy of the certificate of incorporation for its own files, the Secretary of State, for a fee of $1.00 plus $.50 per page, will make a photostatic copy of the certificate filed, affix his certification, and return it to the company.

[13] In some states, Delaware, for example, there must be a meeting of stockholders to accept the charter, before corporate existence begins.

[14] See *Encyclopedia of Incorporating Forms*, cited in note 9, for examples of complete by-laws in long and short form, and for numerous examples of by-law provisions.

tees, these are provided for. One standing committee usually found in large corporations is the executive committee, sometimes, as in the case of the United States Steel Corporation, called the finance committee. Its duty is usually to act in the interims between directors' meetings, making decisions on such problems as may need prompt action. The by-laws of some large corporations provide for a finance committee in addition to an executive committee. Its powers are usually confined to financial matters.

The whole subject of dividends and finance is covered in the by-laws. In small companies the most important provisions are those that permit the directors to choose a bank for the deposit of funds, and empower the proper officers, usually the president and the treasurer, to sign checks, drafts, and contracts. Sometimes a provision is included giving the directors the right to create reserves out of the net profits for working capital, to meet contingencies, or for other purposes. The effect of such a provision is to place in the hands of the directors the right to determine the amount of dividends that from time to time shall be distributed.

Powers of a corporation. A corporation's powers to act may be divided into three classes: (1) those expressed in the charter; (2) those incidental to the express powers; (3) those implied from the fact that the corporation is created to transact business. Thus a corporation may expressly have the power to make and deal in aircraft. Incidentally, it would have the power to start a school of aviation in order to increase its sales. Also among the incidental powers are those conferred by the mere creation of the corporation, like the right to continuous succession, to sue and be sued, to hold property, and to have and use a corporate seal. Because it must carry on its business as business is generally carried on, it would have the implied power to borrow money, to make ordinary contracts, execute promissory notes, draw checks, perform acts to aid employees, and so on. It would be improper, however, for such a company to engage in building ships of the sea, and if it undertook such work, the stockholders might restrain it, since the new venture would involve a diversion of the stockholders' investments.[15]

Directors. As shown in the certificate of incorporation on page 12, the charter usually indicates the number of directors. The number

[15] Acts beyond the power of a corporation are called *ultra vires* acts. The state which created the corporation may take cognizance of the company's breach of its contract by dissolving the company. We say "breach of contract" and mean thereby the contract which the corporation has with the state to be permitted to exist as an artificial person and to do certain things as such person. The laws as to the enforcibility of *ultra vires* contracts by the persons concerned are not uniform, but in general they are to the effect that such a contract entirely performed will not be set aside by the courts and one wholly unperformed will not be enforced by the courts. Where it is performed on one side only, the courts are not in agreement as to the method of treatment.

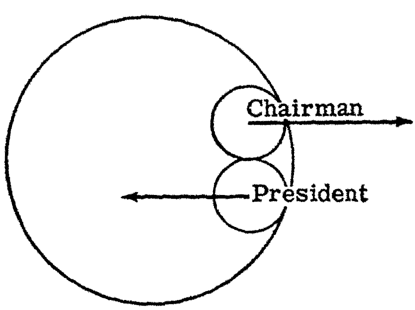
may not be less than the minimum required by law and may be changed at any time within the statutory limits. The corporate powers are exercised, the corporate business conducted, and the corporate property controlled by the board of directors. A discussion of the position of the board of directors in relation to management of the corporation is reserved for Chapter 4.

Officers. The by-laws name the official positions in the company and give the powers of the incumbents. These we may list briefly:

The *chairman of the board* is usually a man of advanced years who has passed the age when he can carry details and manage day-to-day operations. He is the Nestor of the company. His advice is needed on questions of policy and in matters of great importance. His position corresponds to that of senior partner of a firm.

The *president* is the managing director—a position, by the way, that is recognized under that title in French companies (*administrateur délégué*). The diagram below illustrates the relative positions of the chairman and of the president.

These relative positions are further illustrated in the United States Steel Corporation, where Roger Blough is chairman and Clifford F. Hood is president. Mr. Blough, a lawyer, has had varied experience in industrial and public affairs. Mr. Hood spent many years with the American Steel and Wire Company, where he began as a clerk, worked his way up to vice president in charge of operations, and eventually became the president. He understands thoroughly all the operations of a steel plant.



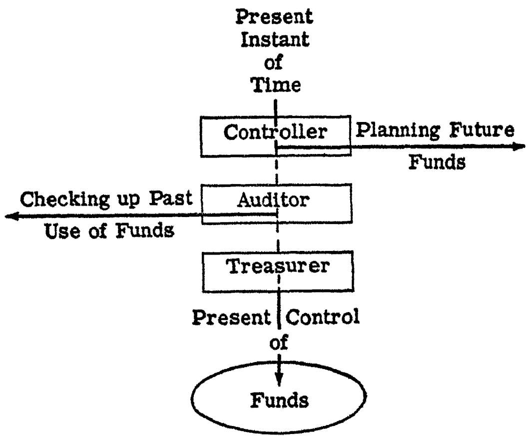
Relative Lines of Activity of Chairman and President of Corporation. Large circle represents the corporation. President supervises internal management; Chairman supervises policies involving outside relations.

The *vice president* in a small corporation holds the time-honored position of one standing ready to take the place of the president. In large corporations the vice president is usually a department head; there may therefore be as many vice presidents as there are departments.[16]

[16] Some corporations have many vice presidents, the theory being that nominal responsibility will induce acceptance of real responsibility. An interesting story is told to illustrate the point. Two men, strangers to each other, met at a golf club and challenged each other to a match. As they strolled along, they got into a discussion of certain financial matters and one disputed the accuracy of a statement made by the other, adding, "I ought to know; I'm vice president of the Blank Trust Company." "That doesn't prove anything," said the other. "I'm a vice president in the Blank Trust Company myself."

The *treasurer* has charge of the funds. His duties usually include arranging relations with banks and procuring funds. He has custody of securities owned by the corporation, and in large corporations he has charge of all distinct funds, such as funds to be used for retirement of preferred stock or bonds.[17] He is usually in charge of the credits and collections department. His assistant will then be called credit manager, or assistant treasurer in charge of credits.

The *controller,* an officer not found in all corporations, has duties that bring him into contact with more phases of the business than any other officer. He is usually at the head of the accounting division; prepares analyses and interprets business results; is responsible for tax matters; and is in charge of preparing the annual budget covering all



Relative Lines of Activity of Controller, Auditor, and Treasurer.

of the activities of the business. Since he must interpret operations in terms of funds, profit, and financial condition, he is in a position to know most about the company's financial position. The responsibilities and importance of the controller's office have increased in recent years.

The *auditor* goes over the accounts to see if the funds have been properly handled and to report to the directors on the financial position of the company. Not every large corporation, and few small companies, provide for the office. The function is performed in many instances by the controller or by outside accountants.

[17] Sinking funds required to be set up by a mortgage securing an issue of bonds are controlled by the trustee named in the mortgage, but it is usually the treasurer's responsibility to see that payments are made into these funds as required by the mortgage.

The relative positions of the auditor, treasurer, and controller are illustrated in the diagram on page 17.

The *secretary,* as his name indicates, is charged with keeping the minutes of the stockholders' and directors' meetings, and with attending to all matters pertaining to such meetings. He has charge of unissued certificates of stock and all important books, records, and documents pertaining to the company's corporate affairs. He is usually custodian of the corporate seal. In some large companies, since he has charge of the important documents, including the leases of property, one of his important duties is to take care of real estate matters. In England the office of secretary is much more important than it is here. In this country, apparently, much of the management of the company, in its strictly corporate affairs, is left to a lawyer or to a professional accountant, whereas in England most matters of that kind are managed by the secretary.

Corporations frequently have assistant officers who sometimes are brought together in council meetings to confer on matters of detail affecting the general routine of the business. It is customary in such corporations to call these councils "junior officers' meetings."

Research Question

From any available source determine the number of shares of common stock authorized and the number of shares issued for the following corporations:

General Motors Corporation
Chrysler Corporation
American Telephone and Telegraph Company
Consolidated Edison Company of New York, Inc.
Northern States Power Company (Minn.)

Problem

Prepare a certificate of incorporation and a set of by-laws for an automobile agency.

CHAPTER 2

Other Forms of Organization

Individual Proprietorship, Partnerships, Joint Venture, Joint Stock Company and Business Trust

The individual proprietorship. The individual proprietorship is the earliest and simplest form of business organization. No formal documents need be drawn and no organization fees or taxes need be paid by a business starting as a sole proprietorship. The owner has the exclusive right to control the operations of the business. If the business prospers, he gets the full benefit of the profits; if it fails, creditors look not only to the assets of the business for payment of their debts, but may take everything, with some unimportant exceptions, that the proprietor personally owns. The individual proprietor thus owns all and risks all. When he dies or becomes disabled, his business is dissolved, sold, or carried on by a successor.

Because of unlimited liability, individual proprietors usually think of incorporating their businesses as soon as they attain any substantial size. An individual can do this and still own the business by giving to others nominal interests and making them co-directors, but requiring that they shall consent to a practical surrender of all authority to him through the simple device of electing him president and writing into the by-laws of the corporation a provision that the president shall be the general manager.

A person who does nothing about the legal form of organization is deemed by the law to have chosen the individual proprietorship form of organization.

The general partnership. The general partnership is a form of business organization in which two or more individuals carry on a business as co-owners for profit. Usually the individuals enter into a written partnership agreement when they decide to engage in business as part-

ners. Among the important points covered in the partnership agreement are (1) the names of the partners and of the partnership; (2) the date when the contract shall become effective; (3) the nature and place of the business; (4) the capital to be contributed by each partner; (5) the duties of the partners and the acts which one partner will not undertake on behalf of the partnership without the written consent of the other (for example, borrow money, assign claims, and the like); (6) the date when the books are to be closed and the profits to be divided; (7) the portion of profits to be allotted to each partner; (8) drawings to be allowed each partner; (9) the length of time the partnership is to continue and the rights of the partners in the event of dissolution; (10) a provision for arbitration of disputes.

General agency in partnerships. In the partnership, each partner is a general agent for the business. This simply means that each partner may make contracts that will bind the partnership, or the firm, as it is sometimes called.

The reader will realize that one should not enter into a partnership with a person whose judgment in making contracts is not good, or with one who, if he agrees to refrain from making contracts, will forget or disregard his promise. Because a partner is an agent, and because in law an agent cannot delegate his authority, it follows that a partner cannot transfer his interest to another person without his partner's consent. So, if a partner dies, goes insane, becomes bankrupt, or withdraws for any cause whatsoever, his executor, guardian, or trustee in bankruptcy does not take his place. In each of these cases the newcomer—the executor, guardian, or trustee—has the right only to make the remaining partners account for and pay over the cash value of the interest of the partner whom the newcomer represents.

Liability of partners; division of profits and losses. The members of a general partnership are jointly and severally liable for the debts of the firm. By this we mean that the creditors may collect from the partners' several private estates if their joint or partnership property is insufficient to defray the debts. When a partner has properly paid liabilities of the firm out of his own funds, he is entitled to contribution from his co-partners if the firm's assets are insufficient to reimburse him. Ordinarily, the contributions are made in the same proportions that apply to the sharing of profits.[1]

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[1] An illustration will make clear the rules relating to partners' liabilities.

A, *B*, and *C* are members of a partnership which has assets of $10,000 and debts respectively to *X*, *Y*, and *Z* of $10,000, $20,000, and $30,000. To prevent any one creditor from seizing the $10,000 of assets, a receiver is appointed by a court of equity to wind up the partnership affairs. *A* owes $20,000 to his private creditors, and has assets worth $10,000. *B* owes $10,000 and has $20,000. *C* owes $20,000 and has $20,000. There is a rule of law, called "marshalling of assets," which provides that in a case like this the partnership creditors have first right to the partnership assets

In the absence of a specific contract, partners share profits and losses equally, though it is customary where partners contribute different amounts of capital to provide in the partnership contract that the profits and losses shall be distributed in the same proportion.[2]

The limited partnership. A limited partnership differs from a general partnership in the following respects: (1) it is organized under the limited partnership laws of a particular state by filing a contract drawn according to the law. If this is not done, a general instead of a limited partnership results. (2) The limited partnership must have one or more general partners and one or more special or limited partners. The liability of the special partners is limited to the amounts they have agreed to put in. Their names must not appear in the official name of the partnership and they can have no voice in the business.

As a limited partnership is a creature of the state in which it is organized, outside of the state of its formation the organization is likely to be treated as a general partnership and then even special partners have unlimited liability to creditors. If, therefore, a limited partnership does busines in another state, it should first file a certificate and comply with the statutes of that state in order to limit the liability of its members.

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and private creditors have first right to the partners' individual properties. Hence, the \$10,000 partnership assets will go to *X, Y,* and *Z, A*'s \$10,000 will go to his creditors, *B*'s creditors will take \$10,000 of his property; and the rest will go to *X, Y,* and *Z* under the rule of the joint and several liability of partners. *C*'s creditors will take all his property. Since *B* will have paid \$10,000 out of his own pocket to help satisfy the partnership creditors, he will have a "right of contribution" against *A* and *C;* that is, if their obligations are not wiped out by bankruptcy, they will each owe him \$3,-333.33.

This division of losses would be followed as to *X, Y,* and *Z,* even if the partners had agreed that *B* should in no event be liable to outside creditors. *X, Y,* and *Z* would collect from *B*, but then *B* would have a claim of \$5,000 against each of *A* and *B*. The point is that one person cannot agree with another that a third person's rights shall be limited, without that third person's consent. If *A, B,* and *C* wished to carry out their arrangement, they should have formed a limited partnership (see above), and then *X, Y* and *Z* would have had notice of *B*'s limited liability and could guard the credit they extend in view of the known restriction on *B*'s liabilities.

[2] The following illustration shows how the partners fare where there are creditors, a debt to one of the partners, and losses that are shared equally. Suppose *A, B,* and *C* contributed respectively \$30,000, \$20,000, and \$10,000 to a business in which they engaged without formal agreement. The firm is wound up and its assets of \$60,000 are all that is left to pay \$50,000 to creditors *X, Y,* and *Z,* besides \$10,000 advanced as a loan by *B*, and the obligations of the partnership to the partners. Here there are losses which amount to the sum of all the debts and obligations, that is, \$120,000, less \$60,000 of assets. This total loss of \$60,000 must be divided equally. Therefore each partner will contribute \$20,000 and will take out the amount of the obligation of the partnership for capital and any debts due from the partnership. *A* therefore will put in \$20,000 and take out \$30,000; that is, he will take out a net of \$10,000. *B* will put in \$20,000 and take out \$10,000 for the debt and \$20,000 for capital; that is, he will take out a net of \$10,000. *C* will put in \$20,000 and take out \$10,000; that is, he will contribute a net of \$10,000. In effect, then, *C* will put in \$10,000, and this with the \$60,000 of partnership assets will yield \$50,000 to *X, Y,* and *Z* and \$10,000 net to each of *A* and *B*.

The limited partnership association. The statutes of Michigan, New Jersey, Ohio, and Pennsylvania permit the organization of limited partnership associations. These are created like corporations, and, in the state of their formation, they have most of the attributes of a corporation. In the state of its organization the members of a limited partnership association are not personally liable for the association's debts. But the members will be held liable as general partners unless the organization strictly complies with the statutes authorizing the organization of limited partnership associations. Outside of the state of their organization, courts have been inclined to treat these associations as general partnerships. This form of organization, therefore, is suited only to a business to be entirely conducted in the state permitting its formation.

Mining partnerships. In Idaho, Nevada, and other mining states there are special mining partnership statutes. No special procedures are necessary for forming such a partnership; it exists when two or more people acquire a mining claim for the purpose of working the mine. The mining partnership is like the general partnership in that the members are personally liable for debts of the company. However, a member can sell his interest without the consent of other partners, and the death, insanity or bankruptcy of a member will not dissolve the mining partnership.

The differences from the general partnership that characterize this form of organization have been dictated by the nature of the industry and those who participate in it. A mine requires continuous and patient operation for successful exploitation; the participants, on the other hand, look for quick results and, if they are not forthcoming, want freedom to move to more promising ventures. Hence the features of transferable shares and continuous existence.

The joint venture. The joint venture, otherwise known as the "joint adventure," "deal," or "syndicate," is very much like the partnership in point of law. The main differences are quite technical and relate to the way in which actions are brought in court. In general effect, of course, the principal difference is that while the partnership goes on indefinitely or for a specifically limited time, the joint venture is organized for a specific purpose and its duration is limited to the accomplishment or definite failure of that purpose. Usually, all the business of a joint venture is done in the name of a manager, who is responsible to the participants.[8]

The joint stock company. A business conducted as a joint stock company has shareholders like a corporation, but the shareholders, like partners, are liable for the debts of the business. Because of the un-

[8] For examples of agreements to form joint ventures, see S. Gordon, *Modern Annotated Forms of Agreement* (New York: Prentice-Hall, Inc., 1947), Chapter 37.

limited liability feature, the joint stock company is not commonly used as a form of business organization.[4]

The contract by which the joint stock company is organized, known as "articles of association," and the by-laws define and regulate its organization and management in much the same manner as the certificate of incorporation and by-laws affect the corporate organization. Usually, the management of the company is vested entirely in the hands of a small board of governors, or directors, periodically elected by the shareholders. Shareholders, unlike partners, are not general agents and cannot bind the association by their individual acts. The business is done by the officers and agents appointed and removed at the pleasure of the board of governors. The board usually has the right to declare and pay such dividends from the earnings of the company as they deem expedient.

As already indicated, each member of the joint stock company is individually and personally liable for the entire debts of the organization. In turn, the member who may be held liable has the right of compelling other members to contribute their share of the loss.

Most of the advantages which common law joint stock companies enjoyed over the corporation, such as freedom from regulation and taxes, have been lost by statutory enactments. In many of the states, the statutes governing the right of a foreign corporation to do business in the state include joint stock companies in their definitions of foreign corporations. Under the Federal income tax law and many of the state annual tax laws, joint stock companies are taxed as corporations, and under the Federal and state laws regulating public offerings of securities, joint stock companies are also treated as corporations.

The business trust. The business trust is a form of organization known by various names. It may be called simply a business trust, or a business association formed under deed of trust, a voluntary association formed under deed of trust, a common law trust, or a Massachusetts trust.[5] The latter term is used because the business trust, as a modern business device, originated in Massachusetts, where the law prohibited the organization of corporations whose purpose it was to own and deal in land.[6] The business trust is based on the principle

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[4] Adams Express Co. is a well-known example of a joint stock company organized under the common law. Created in 1854, to continue until 1998, it was engaged in the general express business until 1918 when its property was sold to the American Railway Express Co., now the Railway Express Co. Other portions of its business were sold to the American Express Co. Today, the company's assets consist of cash and securities and it operates as an investment trust, confining its activities to the investment and reinvestment of its funds.

[5] In this book, "business trust" and "Massachusetts trust" are used interchangeably.

[6] The suspicion of landholding corporations goes back in early English history to the Statutes of Mortmain, the purpose of which was to severely restrict future acquisitions of property by the Church. The cause of the suspicion is the fear that since a corporation has continuous succession, it might continue to increase in size until eventually it might become more powerful than the state itself.

of the personal trust. The object of the personal trust, the traditional type, is to have an experienced person, either an individual or a trust company, hold property to conserve and manage it and pay the income to the beneficiary. The object of the business trust is to conduct a business, the profits from which will be shared by the beneficiaries. In a personal trust, the creator generally makes another person the beneficiary; in a business trust, the creators generally are the beneficiaries.

Organization of a business trust.[7] A business trust is created through the drafting and execution of a deed of trust, which is merely a contract between the trustees and the beneficiaries. (There may be one or more trustees and one or more beneficiaries.) For this purpose the beneficiaries represent not only themselves but such other persons as may later become interested in the trust, either by investing money in it or by buying out, or in some other way receiving, some other beneficiary's interest in it. These interests in the trust are represented by transferable shares evidenced by certificates, which in outward appearance resemble certificates of stock of a corporation. They may be listed and dealt in on the various stock exchanges. The trust may have as many classes of shares as it wishes, with different attributes as to division of income and risk among the shareholders.

The certificate holders correspond to the stockholders in a corporation. They are merely entitled to an accounting and to the income that such an accounting shows. Dividends are distributed by the trustees out of profits, as determined by the deed of trust. As a rule, the indenture gives the trustees wide discretion in the matter of declaring dividends and the same authority over the management of funds as directors of a corporation usually have.

Since the business trust is not created under a statute, when it is formed it pays no organization tax such as is paid by corporations. It is customary to file the trust deed in a public office and to pay filing fees, which are nominal. However, some states have begun to treat business trusts as corporations. In New York, for example, since 1922 they have had to pay the same annual franchise tax as corporations.

Uncertain position of business trusts. With the growth of the business trust as a form of business organization, it has become involved in considerable litigation which shows that its exact legal status varies among the several states. Texas treats the trust as a partnership; in California it is regarded as being in substance a partnership; Kansas considers the trust a corporation that has failed to comply with the

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[7] Such well-known companies as the New England Gas and Electric Association and the American Optical Company are organized as business trusts.

corporation laws. Massachusetts, by statute, has given business trusts the status of associations with shares of stock and requires the deed of trust to be filed. Business trusts are treated as corporations under the Federal income tax law and many other taxing statutes, under laws permitting suits in the firm name, and under Federal and state laws regulating the public sale of securities.

Liability of beneficiaries or shareholders. The uncertain position of the business trust has a direct bearing upon the liability of shareholders. In Massachusetts, where the common law concerning trusts as business associations has been most fully developed, it has been held that provisions in a trust agreement giving the shareholders power to remove the trustees without assigning any cause, and to appoint others to fill the vacancy, and to amend the declaration of trust, demonstrate that the association is a partnership and not a pure trust.[8] It appears, then, that if the shareholders have a right to control the trustees by the power to remove and elect trustees, or to elect them periodically, or if the shareholders have a right to manage the property themselves, the association will be considered a partnership, and the shareholders will be personally liable. On the other hand, if the trustees act as principals and are free from the control of certificate holders, a trust is created and the shareholders are not personally liable.[9] Even where the trust may be considered a partnership because of the control the shareholders may exercise over the trustees, the liability of the shareholders may usually be restricted by a clause in the trust deed.

Liability of trustees. In dealing with outsiders, trustees are personally liable, unless they clearly indicate that they are acting as trustees and that only the trust property is liable. In contracts with third parties, trustees usually stipulate that the "creditor shall look only to the funds and property of the trust for all payments, and not to the trustees or shareholders personally." This stipulation has been held valid.[10] Furthermore, the trust deed itself usually provides that if the trustee shall ever become personally liable as trustee, not as a result of his acts in bad faith, he may be indemnified out of the trust property.

Research Question

By reference to state statutes determine the limited partnership laws of the state within which you reside. Discuss briefly the protection afforded partners under these laws as against the protection afforded by a general partnership.

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8 Frost v. Thompson, (1914) 219 Mass. 360, 106 N.E. 1009.
9 Williams v. Milton, (1913) 215 Mass 1, 102 N.E. 355.
10 Rand v. Farquar, (1917) 226 Mass. 91, 115 N.E. 286.

Problem

Mr. Jones, Mr. Edwards, and Mr. Grey become partners, contributing respectively, $40,000, $20,000, and $10,000 to the capital of the business. Mr. James is subsequently accepted by them as a limited partner and contributes $5,000 capital. After a few years it becomes apparent to all that the business will not return a reasonable profit and the partners decide to liquidate. The assets of the business net $90,000 before claims of the creditors in the sum of $47,000 are paid. There is no provision for distribution of profits or losses in the original agreement, and to date they have been distributing the profits, when there were any, equally. How should the partners disburse the $90,000?

CHAPTER 3

Comparison of Forms of Organization

Considerations in the choice of organization. Having described all the forms of business organization briefly, we may now compare them with respect to important questions that are likely to arise when a new business is to be formed or when an old one is to be reorganized. In any given case the ultimate choice must depend largely on the peculiar circumstances of the business or the objects that the organizers have in mind.

Two major considerations generally influence businessmen in the choice of a form of organization: (1) the ease of raising capital, which is affected by such factors as liability of owners, transferability of ownership, and the stability of the form of organization; and (2) taxation. The major influences will be discussed first. Then the various forms of organization will be compared from the standpoint of ease of organization, control of the business, functionalization of management, freedom of movement, freedom from governmental control, and the legal status of the business form. Although the selection of a form of organization rarely hinges upon any one of these factors, the comparison is included in this chapter to bring out in summary form the differences between the various forms of organization.

Ease of raising capital. When a new venture is to be started, the promoters estimate the amount of funds that will be required for the new enterprise. If those interested in the organization have the required capital themselves, and are ready to risk it in the business, some factor other than ease of raising capital will generally determine the choice of form of organization. The question of ease of raising funds is important if permanent capital must be obtained from outsiders to start the business or if the promoters anticipate that capital will be needed for expansion in the future if the venture proves successful. Such businesses must choose a form of organization under which it will be easy

to finance the venture. The factors that must usually be present to interest outsiders in investing in an enterprise are: (1) limited liability, because the investor wants to know at the outset the extent of his risk; (2) transferability of ownership, because he likes to feel that he can get out of the venture at any time; and (3) stability of form of organization, because he does not want to find suddenly that a business in which he has profitably invested his funds must terminate because the law says it must. The various forms of organization must therefore be compared on the basis of these three factors.

Liability of owners. In every form of business the assets of the business must go to creditors before the owners can withdraw even their capital. If the business property cannot satisfy the creditors, the owners always face the question of whether they will have to contribute out of their individual means, and if so, to what extent. The principal questions here involved were discussed when we described the various forms of business. The sole proprietor risks everything, as do general partners. The special partners risk only the amount they agreed to invest. Stockholders also risk only their investment, because of limited liability. Members of a joint venture and members of a joint stock company take the same risks as partners. Shareholders in a business trust may enjoy limited liability, but, as we have seen, that form of organization may meet with trouble on the liability question because the shareholders may be considered partners in some jurisdictions.

Although we are discussing liability of owners from the viewpoint of ease of raising capital, it should be mentioned here that it is an important factor in determining whether or not the organizers are to seek outside capital. Many businesses are organized as a corporation principally because of the limited-liability feature.

Transferability of ownership. Businesses that issue stocks or other transferable certificates of ownership have an advantage in raising funds because ownership is easily divisible and the shareholder is free to sell his interest in the venture at any time. Also, he can easily make a gift of his interest in the business or transfer the title to his shares for any reason whatever. The transferability feature is available in the corporation, joint stock company, and business trust.

Stability. The sole proprietorship and the partnership are quite unstable; their existence is affected by the death, insanity, or bankruptcy of the owners. Other forms, such as the corporation, joint stock company, and Massachusetts trust enjoy stability or continuous succession through the transferability of shares. But they do not all have "durability." The busines trust is usually of limited duration; the corporation has limited duration in those states where a corporation is not permitted to be formed for an unlimited period. However, in any of the forms of business organization that have continuous succession,

limited duration is not a serious matter, for renewal or extension of existence is easily achieved. A business that does not have continuous succession cannot raise funds by making long term loans through the issuance of bonds.

Summary. The corporation has the best combination of the three elements sought by investors in business enterprises—limited liability, transferability of shares, and continuous existence. It is therefore the most appropriate legal form of organization for businesses requiring large amounts of capital. Thus, railroads, telephone companies, gas works, and industries that require large investments in plant and equipment are invariably organized as corporations.

The corporation may raise permanent capital through public or private offerings of stocks, if it wants to spread the ownership of the enterprise, or by issuing bonds, notes, and other securities evidencing indebtedness, if it desires to borrow for long periods. Because both stocks and bonds can be created with different provisions concerning the income which investors will receive, the security of their investment, and the control they will have in the enterprise, the corporation can appeal for funds to all classes of investors—large, small, ultra-conservative, conservative, and speculative investors. The division of stock into classes and the methods by which income, risk, and control are varied will be explained in Chapter 5, when we discuss the characteristics of stock. The variations in income, control, and risk possible in bond issues will be explained in the chapters dealing with corporate borrowing.

From the standpoint of Federal regulation of the issuance of securities, all forms of business organization that finance their enterprises through public offerings of stocks, bonds, notes, and other securities are treated alike. All must conform with the Securities Act of 1933, which requires the registration of securities that are to be offered publicly through the channels of interstate commerce, unless exempt. (See page 272.) Similarly, compliance with state blue-sky laws, discussed more fully at page 227, may be necessary before offerings may be made of stocks, bonds, and other securities.

The sole proprietorship and the general partnership are the forms least able to attract outside capital. The sole proprietorship and the partnership may raise funds by inducing people to become creditors, and the partnership, in addition, may take in new partners. Both of these forms of organization are used by comparatively small businesses that require no more capital than can be contributed by the sole owner or the partners. The partnership form is commonly used in professional practice by lawyers, management consultants, accounting firms, and others, in which the relations of the firm to the clientele involve a personal responsibility. Indeed, in many states certain forms of busi-

ness may not be incorporated because the law insists upon the client and customer coming into direct relationship with the person who should assume professional responsibility. The corporation is too impersonal where personal service is important. Since personal-service businesses are not likely to need large sums of capital, the restriction to the sole proprietorship or partnership form of organization is no hardship, so far as financing is concerned.

Taxation. Large-scale businesses are practically obliged to select the corporate form of organization because it is the only one under which it is possible to raise large amounts of capital. For such businesses, taxation is not a determining factor in the choice of a legal business form. Where it is practical to operate a business either as a sole proprietorship, a partnership, or a corporation, taxation usually becomes an important consideration. A small business that is to be closely owned would be concerned with this question.

To arrive at any conclusion as to the relative tax burden of doing business under the unincorporated or incorporated forms, attention is usually given principally to the Federal income tax. The following provisions of the Federal income tax law are basic in making the comparison between the unincorporated and the incorporated forms.

Sole proprietorship or partnership. 1. A business organized as a sole proprietorship or a partnership does not pay an income tax as a business unit.

2. The sole owner of a business pays an income tax on all of his income from his business whether it is left in the business, taken out as salary, or withdrawn as profits. He is taxed at the rates applicable to individuals.

3. In a partnership, each partner pays income tax as an individual on his share of the partnership profits whether it is withdrawn or not. The salary paid to each partner is immaterial; it merely enters into the computation of the portion of the profits going to each partner. Partnerships must report their net income in order that the authorities may check on the amount of income reported by the several partners to whom the income is taxed.

Section 1361 of the Internal Revenue Code of 1954 allows certain proprietorships and partnerships to elect to be taxed as corporations. Once the election is made, it is normally binding for all subsequent years. However, even though a proprietorship or partnership elects to be taxed as a corporation, the owners are not considered employees and cannot avail themselves of the special tax privileges that are available to executive-stockholders (see page 33).

Incorporated business. 1. A corporation pays income tax as a business unit. The salaries it pays to stockholders are deductible in arriving

at its net taxable income. Dividends declared by the corporation are not deductible since they are distributed profits.

2. Salaries paid to stockholders are income to them. Dividends paid by the corporation are income to the stockholders. Dividends, therefore, are taxed twice, once to the corporation (as part of its earnings) and again to the stockholders.[1]

3. The corporation cannot arrange its salary and dividend policies solely to effect a low tax for the stockholders because (a) the corporation can deduct salaries only to the extent that they are reasonable, and (b) earnings that are not needed in the business must be paid out in dividends; otherwise the corporation may be subject to a penalty tax under Section 531 of the Internal Revenue Code. Thus, a corporation cannot free itself from corporation income tax by paying out all of its income in salaries, nor can it avoid all tax on its stockholders by paying no dividends or salaries.

Sections 1371–1377 of the Internal Revenue Code, enacted in 1958, give the stockholders of certain corporations an election to be taxed as partners. The election privilege is limited to stockholders of corporations having only one class of stock owned by not more than 10 individual stockholders, including estates. In the years in which an election is in effect, the corporation is not taxed. The election privilege enables an eligible business to operate in corporate form without the notorious double tax burden at both corporation and stockholder levels.

Thus we see that, although taxation is still a weighty factor in the selection of a form of business organization, under present law, in view of the election privileges given both partnerships and corporations, a man or group can choose the form of business organization on the basis of traditional factors, without undue tax penalty under either form.

Computation of tax burden in choosing form of business organization. To the all-important question of the form of organization, the election privilege adds another question: Shall we elect or not? There is no single answer for all circumstances. Where the tax results are not obvious, to find out which form would be most economical taxwise, facts and estimates must be brought together. Then actual computations must be made of the income taxes to which the business and the owners would be subject if one or another form of organization were used. Although the election privilege introduces another impor-

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[1] Under Section 116 of the 1954 Internal Revenue Code, each stockholder is allowed to receive $50 of dividends tax free. Section 34 affords further relief in that each stockholder is given a credit against the income tax he has to pay equal to 4 per cent of the dividends he has received.

tant factor to be considered, it does not change the basic method of analyzing the problem. The analysis that follows applies to the choice of election as well as to the choice of the form of organization.

Suppose it were practical to operate a business either as a partnership or a corporation, and there were no obvious certainty as to which form would result in lower taxes. To determine which form would be most economical income-taxwise, the organizers would do the following:

1. Estimate the anticipated respective net incomes of the partners, if a partnership were formed, and compute the income tax at the prevailing individual tax rates applicable to each partner. An individual includes in his gross income not only his business income, but other income such as rents, royalties, dividends, and interest. Since the individual income tax rates increase as the amount of taxable income increases, each partner's income from sources other than the business may have an important influence on the results of the computation. (If the owners of a corporation were considering exercising the privilege of being taxed as partners, then the respective income of the stockholders would be estimated.)

2. Estimate the taxable net income of the corporation. This calls for an estimate of the salaries that would be paid to the stockholders who would presumably be employed by the corporation. Compute the income tax of the corporation at the prevailing corporation rates.

3. Estimate the income tax of the stockholders from salaries paid by the corporation and dividends received from the corporation and compute the income tax payable by each of the stockholders at the prevailing individual rates. (What was said under point 1 as to income from other sources applies here as well.)

4. Compare the total income taxes of the partners (or owners of an electing corporation) with the sum of the income tax on the corporation and the total income tax on the stockholders. Whichever total is lower would be the more desirable form from the standpoint of the Federal income tax.

From the above explanation it is clear that the tax factor is usually studied on the basis of the laws as they exist at the time that the question of choice of organization form arises. The laws, it must be remembered, are constantly subject to change. The conclusions reached with regard to the relative income tax burdens on incorporated and unincorporated businesses under a tax law that imposes low rates on individuals and high rates on corporations may not hold under a later tax law that leaves the individual rates unchanged and lowers the corporation tax. Of course, business organizations may be revamped, but the process is always costly.

Although the choice of legal organization on the basis of its effect

upon the Federal income tax usually comes up only when the organizers can select the sole proprietorship, general partnership, or the corporate form, mention should be made here of how other forms of organization are treated under the Federal income tax law. Limited partnerships may be taxed as partnerships or corporations, depending upon their characteristics. Joint ventures may be classed as partnerships or corporations, and joint stock companies as corporations. A trust that is organized to conduct business and earn income in the same manner as other enterprises is regarded as a corporation.

The Federal income tax does not, of course, cover the whole tax program. There are other Federal taxes to be paid, such as the social security tax, the unemployment insurance tax, and the various excise taxes. These taxes are usually unimportant insofar as the choice of a form of organization is concerned. There are also many state taxes to which a business may be subject, such as franchise and license taxes, unemployment insurance taxes, state and local business license taxes, and local property taxes. Some of these would vary with the form of organization; others would not. Then, of course, there are the Federal and state stamp taxes which apply to corporations. Almost every law imposing these taxes gives some official the right to call for books and documents on a moment's notice. For example, state inspectors may call on New York corporations and ask to see the stock transfer books to ascertain whether the proper stamps have been affixed to meet stock transfer requirements.

Special tax advantages to owners. From the standpoint of the owners of a business, as distinguished from the business entity, the corporate form of organization offers special tax advantages to the owners who are also executives of the corporation. They are considered employees and are entitled to all of the tax privileges specifically reserved to employees by the Internal Revenue Code. Partners and proprietors are not considered employees and these privileges are not available to them. Among these tax advantages are those derived from (1) stock options, (2) pension and profit-sharing plans, (3) group insurance, (4) death benefit payments, (5) medical payments and wage continuation plans, and (6) meals and lodging.

Stock options. One of the most important of these employees' privileges is the availability of the stock option. Substantial interest in an expanding business may be acquired with a minimum of tax cost through the use of stock options. A corporation may give its executive-stockholders an option to purchase stock at less than the market price. If the option meets certain statutory requirements, it is a *restricted* stock option, and the difference between the market price and the price the employee pays is not considered income to the executive-stockholder. However, in the case of a closely held corporation, it is

often difficult to establish the fair market value of the stock of the corporation. If the Treasury Department should determine and sustain a value materially in excess of that relied upon by the corporation so that the option does not meet the statutory requirement, the option will automatically fail to qualify as a restricted stock option.

Pension and profit-sharing plans. Under the corporate form, the executive-stockholder may obtain the tax benefits of pension and profit-sharing plans that meet the requirements of the Internal Revenue Code. Partners and sole proprietors do not qualify as employees and are therefore deprived of the benefits of participating in these plans. For the tax advantages of these plans to both the corporation and the employee, see "Employee pension and profit-sharing plans," page 363.

Insurance. Premiums on group life insurance policies paid by the corporation, the beneficiaries of which are designated by employees, are not income to the executive-stockholder. Proceeds of a group policy are exempt from income tax as amounts received under a life insurance contract. Since neither partners nor sole proprietors are employees, they are not eligible for the benefits of group insurance.

Medical payments and wage continuation plans. Under the corporate form, the executive-stockholders may have their entire medical expenses and medical insurance paid for by the corporation. These payments may be deducted by the corporation even though the benefits are extended only to a limited number of individuals, or to a single individual. The executive-stockholders receive no income as a result of such payments. The executive-stockholders are entitled to the benefits of wage continuation plans during a period of sickness; that is, they may exclude up to $100 a week of compensation received during periods of sickness. These payments are deductible by the corporation.

Meals and lodging. The value of meals and lodging furnished the employee for the convenience of the employer is not taxable to the employee, under certain conditions, but their cost is deductible by the employer. Corporate executives can avail themselves of this statutory privilege because they are employees. A sole proprietor cannot, and neither can partners.

Ease of organization. The simplest form of organization is the sole proprietorship. Partners may get together with a simple agreement to contribute definite sums and to divide the profits and losses in certain proportions. The law will infer all the rest, and the terms thus inferred, it should be added, will be in most cases very satisfactory. A joint venture may be, and very frequently is, organized in the same simple way. The organization of a limited partnership should be left to the experienced lawyer, because the limited partnership agreement must comply closely with the provisions of the law or a general partnership

will result. Organization of the Massachusetts trust, the joint stock company, and the corporation should also be left to the lawyer.

Control of the business. In the sole proprietorship, ultimate control is completely concentrated in the proprietor. In the general and limited partnerships, excluding in the latter case the special partners who have no voice in the management of the business, control rests in all the partners equally, except to the extent that they agree to apportion the various functions of the business. In the joint stock company and in the corporation, control is centered in the board of directors who are elected by the shareholders. In both of these forms of organization, the control may be almost entirely divorced from the other elements of ownership or may be distributed among the owners according to various plans. For example, in the corporation in some states the directors need not be stockholders, and in other states the number of shares they need to hold is usually so small that the ownership is practically nominal. Other methods of apportioning control through the voting rights given to stockholders will be discussed in a later chapter. In the business trust, control is centered in the trustees. The stockholders cannot exercise control; if they do, they turn the enterprise into a partnership.

Functionalization of management. When a business is small, the individual proprietorship has great advantages in the ease with which duties and powers may be delegated. The proprietor may constitute that form of government which political scientists in the past generally agreed was the best theoretical form of political government, namely, benevolent despotism. The proprietor may delegate various powers to various agents, and so long as he does not clothe them with the appearance of general agents they will have only such powers as are delegated to them. Moreover, the proprietor himself forms the single co-ordinating force. When the business grows, he needs intermediary co-ordinating elements. Gradually he has to build up a personnel of subordinates of various ranks to communicate and supervise the carrying out of his orders.

When the business gets to this size, the principle of standardization begins to operate. The operations become so complicated that wherever possible they have to be standardized, and the elementary units of the business get farther away from the proprietor. But all the same, questions of policy become more important, and these usually are best attended to by one who has directed the concern and knows its traditions and history. For this reason, even large successful corporations commonly elect the same chief executives year after year.

The general partnership would appear not to be susceptible to scientific organization because each partner is a general agent. However, in practice, there is usually an agreement among the partners

as to what their respective duties shall be, and they observe the limitations on the scope of their activities in the business as agreed. Frequently, the duties of each partner are set forth in the partnership agreement. Of course, any agreement on the division of powers among the partners is binding only on persons who know the terms of the agreement.

In a limited partnership, management is arranged as in a general partnership, with no duties whatever assigned to the special partner.

The joint stock company and the corporation may easily functionalize the management, as we have seen, through the appointment of several officers to take care of various duties. Thus everybody would know, and would be bound by his knowledge, that a "vice president in charge of sales" has no right to do the purchasing for a corporation.

In business trusts the duties and powers of the trustees are governed by the provisions of the instrument creating the trust. In the absence of specific provision the general rule is that the trustees must cooperate. But this merely means that all the trustees must be permitted to be heard. It does not mean that every decision must be unanimous, for when all have been given an opportunity to be heard, a majority will govern. If the deed of trust is properly drawn, it will provide either directly for a division of powers among the trustees, or will permit the trustees to organize themselves on the functional plan. Thus it will be seen that as far as management is concerned, the business trust may be made very flexible.

The joint venture is usually managed by one person, who appoints employee agents. This form of organization, therefore, is from this standpoint comparable to the individual proprietorship.

Freedom of movement. The right to do business anywhere in the United States is not very important for some concerns, such as, for example, a retail establishment with a single place of business, or a manufacturing concern with one plant, the product of which is sold locally or distributed through a single independent agency. But where, as is so frequently the case, branches are to be established in different states, and agents sent out, the choice of a form of business ownership must take into consideration this problem of the right of the business to move about with little special interference.

Within the United States, on account of the constitutional provision that "the Citizens of each State shall be entitled to all Privileges and Immunities of Citizens in the several States," those forms of organization which do not in any sense create an artificial entity have an advantage. If, for example, *A* is a citizen of Illinois and wishes to carry on the business of selling textiles in New York, he may do so in that or any other state of the Union without paying any greater taxes or

incurring other obligations greater than those imposed on the citizens of those states. To be sure, the selling of textiles in some states may for special reasons be considered to so affect the health, welfare, or morals of the people as to make it expedient to permit only licensed persons to carry on the business. But even in those states, *A* would not have to pay any greater license fee than a resident.

A limited partnership, in each state and each country where it does business, must comply with the local rules applicable thereto. A general partnership, however, may generally be regarded as a simple collection of individuals and may move about as an individual might. And the same is true of a joint venture. Joint stock companies are entitled to the constitutional protection intended for citizens and cannot be placed under unusual burdens.

The corporation is not a citizen and hence may be kept out of any state in the United States, or may be admitted only upon compliance with special conditions. Because each state wants its corporations to enjoy freedom of action in other jurisdictions, it ordinarily permits properly qualified foreign corporations to come within its own borders.[2] The tendency seems to be for business trusts to be regarded as corporations when entering the states to do business therein.

Freedom from governmental control. This is not the place to go into a discussion appropriate for political science or political economy. But the relation of these subjects to our immediate inquiry is very intimate. At one time business was regulated chiefly because it contained abuses. That was the "thou shalt not" stage. Now government is regulating business largely for a positive social purpose, not only by taking property from business for largely increased public operations by means of taxes, but also by telling some businesses what service they shall render, and how much they shall charge. Regulation depends not so much upon the form of organization as upon other factors. For example, on the whole, large businesses are much more burdened than are small ones, irrespective of form of organization. Certain businesses—those affected with a so-called public interest—are more completely regulated than those deemed private. The fact is, however, that the courts have almost entirely abandoned the right to review the legislatures in the matter of classification of businesses for purposes of con-

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[2] Qualifying generally consists of paying the proper taxes, filing certain documents for identification, such as a copy of the certificate of incorporation, the by-laws, a statement of financial condition, and the amount of capital and assets to be employed in the state, and designating some person to receive service of legal papers. A corporation that does business in a foreign state without qualifying is subject to certain disadvantages and penalties. The disadvantages and penalties may include fines, loss of the right to sue or defend in the state courts, invalidity of contracts, and civil personal liability and criminal liability of officers, agents, or employees of the corporation.

trol, and today almost any business is affected with a public interest if the legislature so determines.

But there are certain government interferences that are based on the classification of businesses according to form of ownership. Corporations, for example, are required to prepare reports in every state within which they do business. They pay taxes for the privilege of being a corporation and doing business as such in the several states. The tendency is to treat joint stock companies and Massachusetts trusts in the same way. Limited partnerships, being creatures of the state, likewise may be discriminated against. The burden that might be placed on them would simply be the price of the privilege of limited liability. It should be said, however, that in practice, limited partnerships, for this purpose, are generally classed with general partnerships. The sole proprietorship and the general partnership have the greatest freedom.

Legal status of business forms. But there is another phase of the question that we shall do well to consider here, namely, the legal status of the various forms of business. The status of the individual proprietorship and of the general partnership is well established by a long line of court precedents touching on every conceivable phase of the relationship. These long-established rules have been codified for the partnership in a uniform partnership law; they have been modified only slightly by statutes in some of the states that have not adopted the Uniform Partnership Law. When you deal with a partnership or on behalf of a partnership, you know what to expect when contingencies arise.

On the other hand, corporations are governed little by court precedents, but much by statutes. These statutes have developed along very different lines in the several jurisdictions and even the best corporation lawyers can hardly hope to remember the detailed rules of more than one or two states. Whenever a situation arises that is governed by the rules of another state, the latter's statutes and the decisions thereunder must be consulted carefully. Even this difficulty is aggravated oftentimes by the fact that the statutes of a state are carelessly worded and have not been interpreted by the courts. The laws in a few states have been amply interpreted and when we form corporations in them we know the legal status of all aspects of corporate relations. This certainty of legal status is one of the reasons why corporate organization is concentrated in a few states.[3]

Massachusetts trusts are meeting with trouble because of diversity of laws. Lawyers would hardly recommend this form of organization where the enterprise is to carry on an active business in a number of jurisdictions.

[3] See page 11 for more important reasons.

Research Question

From state statutes or any other source, determine how a corporation organized in a state other than your own can qualify to do business in your state.

Problem

Prepare a chart comparing the various forms of business organization with respect to:

(a) Ease of raising capital.
(b) Taxes.
(c) Ease of organization.
(d) Control of business.
(e) Freedom of movement.
(f) Freedom from governmental control.
(g) Liability of owners.

CHAPTER 4

Corporate Management and Control

Approach to the subject. We now leave all of the forms of business organization, except the corporation, behind us and concentrate for the remainder of this book on corporate financial organization and management. In this chapter on management and control, we shall explore in detail the relative positions of the stockholders, who are the owners of the enterprise, and of the directors who manage it for them. After the corporate system of management has been described, we shall summarize the weaknesses from the social viewpoint inherent in the system and shall present the remedies that have been and that might be applied to correct those weaknesses.

How corporations are managed. The fundamental authority in the management of a corporation rests with the stockholders who have voting power, since they periodically elect the directors to whom is delegated the general supervision of the business. In many states the laws provide that certain matters of importance—those which affect all the property of the company at one time—must be referred to the stockholders. Such important matters, for example, as a sale of the assets, lease of all the assets, consolidation with another company, increasing or decreasing the capital stock, or amendment of the certificate of incorporation, cannot be put through without the consent of the proportion of the stockholders designated in the law or in the certificate of incorporation.

The directors are the elected representatives of the stockholders. When, as in the case of a small or close corporation, there are but a few stockholders, they elect themselves as directors and thus, in effect, represent only themselves. The directors are the general managers of the business, not acting singly, but as a board. The details of management are left to the officers who are in charge of the operating personnel. The officers as a group are subordinate to the directors and

have only the powers given them by the articles of incorporation, the by-laws, or the directors. As was pointed out earlier, large corporations usually have an executive committee that decides matters in the interval between directors' meetings.

By the way of summary, then, we may say that the ordinary questions that arise in business are decided by the officers; more important questions are referred to the executive committee; larger questions of policy that can be reserved for more formal discussion are taken up at the directors' meetings, which usually occur once a month; still more important questions are taken up at the annual meeting of stockholders or at meetings of stockholders specially called.

This pattern of corporate management applies to small corporations as well as large. To be sure, the closely-owned small corporation acts with much less formality than the large corporation, but it is subject to the same laws as large corporations. The statutes make no distinction between large and small corporations.

Voting in a corporation. Every owner of capital stock has a right to vote his stock at all meetings of the stockholders as an incident to the ownership of the shares, unless the right is denied by some specific contract limiting or abridging this right. A provision in the certificate of incorporation, for example, might limit the voting rights of a class of stockholders. Since each director is the elected representative of the stockholders and *his* judgment is necessary when the board makes its decisions, directors cannot delegate to other persons the right to vote at directors' meetings on corporate matters.[1] Stockholders, however, are usually given the right to vote in person or through an agent known as a "proxy." We shall explain proxies later in this chapter.

Whereas at common law the rule is that each stockholder has one vote, the statutes of the states usually provide that each stockholder shall have as many votes as the number of shares he holds, unless the stock is non-voting.

Non-voting, vetoing, and contingent-voting stock. Frequently, a certificate of incorporation will provide that a certain class of stock shall not have the right to vote at all. Sometimes the voting stock represents a much smaller ownership than the non-voting stock.[2] Generally, it is the preferred stock of industrial and public utility companies that is deprived of voting power. The preferred stocks of most of the railroads have voting power, principally because these issues were created in reorganization proceedings in which bonds were exchanged for pre-

[1] Some states do permit a director to cast a written, absentee ballot when the directors are unanimously agreed on a specific course of action. However, where this type of action is permitted, the directors are casting their own votes on a *specific* question. That is quite different from delegating the power to cast a vote on anything that might come up at the meeting.

[2] See example of H. C. Bohack Company at page 63.

ferred stock. Having been deprived of their fixed incomes as bondholders, and having been given preferred stock with a low dividend rate, and non-cumulative to boot,[8] the old bondholders seemed at least entitled to the same voting rights as other stockholders.

Absolute deprivation of voting power is not as usual, however, as limitation of voting power. Thus, in many corporations a class of stock which has no right to elect directors will have voting power on questions that peculiarly affect the relation of the group to the corporation. Such stock may be called vetoing stock. Frequently, this power to vote on certain questions is included to meet the requirements of the law under which the corporation is organized.

Sometimes non-voting stock is given the right to elect or assist in electing directors under certain circumstances. Such stock may be called stock with contingent voting power.

Questions upon which vetoing stock is frequently given right to vote. The matters upon which stock that is non-voting will be given the right to vote, and thus have vetoing power, usually include the following:

1. Authorization of an increase in the issue of preferred stock. If a corporation has no bonds outstanding, its preferred stock will have the first claim on its earnings. If there is to be any new financing, the common shareholders will not care whether the preferred stock is increased or a new class of second preferred is created. But to the old preferred stockholders the difference is of great importance. Carefully drawn charters, therefore, usually provide that special consent of the preferred stockholders must be obtained to increase the preferred stock.
2. The authorization of an issue of stock that will have a claim on the earnings or property of the corporation prior to that of the particular issue involved.
3. The making of mortgages or liens. Purchase money mortgages are often specifically excepted.
4. The issuance of bonds, notes, or other evidences of debt.
5. The sale of the corporate assets, merger, or consolidation.
6. Other subjects upon which non-voting stock may have the right to vote include a change in the by-laws of the corporation; a change in the preferences, privileges, or other characteristics of the stock, such as a change in its par value; a change in the voting power; dissolution; a change in the purposes of the corporation; guaranties.

Contingent voting rights. Variations in the arrangements for coningent voting power are limitless. No one issue is likely to include pro-

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[8] Non-cumulative preferred stock is explained at page 76.

vision for voting under all the contingencies enumerated below, but numerous examples can be found to illustrate each.

Frequently, although the preferred stock does not have the right to vote under ordinary circumstances, that right begins to operate when dividends on the preferred are passed for a specified number of financial periods. In some instances, the right to vote is given if earnings fall below a certain level. Giving non-voting stockholders the right to vote in case dividends are passed is based upon the theory that the holders of non-voting stock are entitled to voting power in order to protect their dividend rate.

Other contingencies have been made the basis for giving non-voting stockholders voting power. Thus, the right to vote may be given if the corporation fails to maintain net assets, net tangible assets, or net quick assets up to a prescribed standard. Similarly, non-voting preferred stock may become voting upon failure of the corporation to redeem preferred stock, or to make sinking fund payments.

Great variety is found in the extent to which the non-voting stock becomes voting upon the occurrence of the defaults. In many instances the non-voting stock obtains exclusive power to vote for directors until the default is corrected; in others, the non-voting stock acquires equal voting power with the regular voting stock, and in some cases extra voting power is given. Another arrangement permits the preferred stockholders to elect a majority or a certain number of the directors during the period of default.

Non-voting stock criticized. At one time, corporation stock issues showed a decided tendency toward concentration of control and restriction of voting rights to certain classes of shareholders. The tendency was inspired by the desire of the organizers to control the corporation with a comparatively small amount of invested capital. If the organizers hold all the voting stock, they can finance the corporation through the sale of unlimited amounts of non-voting stock without losing control.

When the trend toward classification in voting rights reached the place where part of the common stocks as well as all the preferred stocks were being deprived of voting power,[4] a great deal of criticism developed. The principal objection raised against non-voting issues is that stockholders who should have the right to object to the manner in which the management is conducting the business can do nothing about replacing the inefficient managers.

The Public Utility Holding Company Act of 1935 seeks to curb

[4] This was accomplished by dividing common shares into two classes, one denominated Class "A" and the other Class "B," with voting power denied to one of the classes of common. See page 75.

the abuses that resulted from the issuance, especially during the twenties, of stock without voting rights or with restricted voting rights. The Act gives the Securities and Exchange Commission considerable power to see that the corporate structure of public utility companies subject to the law does not unfairly or inequitably distribute voting power.[5] The amended Bankruptcy Act also seeks to avoid abusive concentration of control through voting restrictions by requiring that the plan of reorganization must provide for equitable distribution of voting power. Non-voting common stock is prohibited in the reorganized company, and preferred stockholders must be given the protection of adequate provision for election of directors by them in the event of default in the payment of dividends.

State public service commissions, which have jurisdiction over public utilities and approve or disapprove their petitions to issue new securities, have sometimes refused to permit a company to create non-voting preferred stock as against public policy.

Since 1926 the New York Stock Exchange has refused to list non-voting common stock.[6] Because of this policy, all common stocks now listed on the New York Stock Exchange have voting privileges. The New York Stock Exchange will not list new preferred stocks that do not provide at least the following minimum voting rights: (1) the right of the preferred stock, voting as a class, to elect not less than two directors after default of the equivalent of six quarterly dividends; and (2) the affirmative approval of at least two-thirds of the preferred stock, voting as a class, as a prerequisite to any charter or by-law amendment altering materially any existing provision of such preferred stock.

Cumulative voting. Complaints have frequently arisen that majority stockholders oppress the minority. Under the old-fashioned rule of voting, which still prevails in many corporations, the stockholder is entitled to cast a number of votes equal to the number of shares he holds, for one candidate for each position on the board of directors. Where, for example, five directors are to be elected, a person holding 51 shares out of 100 shares of stock can elect his five candidates. To prevent this situation, a system of cumulative voting has been devised which in some states is prescribed by the statutes or the constitution of the state, and in other states is often included as a part of the machinery of management provided in the certificate of incorporation.

[5] See note 10.

[6] In 1957 the New York Stock Exchange adopted additional rules that prevent the listing of stock that limits the stockholder's right to vote. The Exchange now refuses to list the voting stock of a company that has publicly-held, non-voting common stock outstanding, and it will not list voting stock of a company if the right to vote is restricted by a voting trust, irrevocable proxy, or any similar arrangement to which the company or any of its officers is a party.

Under this system of voting each stockholder has as many votes as is equal to the number of voting shares he owns multiplied by the number of directors to be elected. These votes he may accumulate for one candidate or may distribute among the candidates for election in any way he sees fit.

In the example cited above, the majority stockholder would have 255 votes (51×5) and the minority interests would control 245 votes (49×5). If the majority contents itself with casting this cumulative vote for three out of five directors, it can secure their election by giving each director 85 votes. The minority may elect two directors by giving one of the directors 122 votes and another 123 votes. In this case, if the majority frittered away its strength among five directors, while the minority concentrated its strength upon four, the minority would gain control of the board.[7]

Staggered terms and cumulative voting. Cumulative voting operates to give representation to minority groups if all directors are elected at the same time. If the terms of the directors are staggered so that only one or a few are elected each year, a minority might be prevented from electing any directors even though cumulative voting is permitted. In any event, staggering of the terms of directors (also called "classification") dilutes the stockholders' maximum voting strength under cumulative voting.

For example, in the case of a nine-member board, if all members are elected at the same time and cumulative voting is permitted, the owners of 10 per cent of the stock plus one share can elect one director. However, if the terms of the directors are staggered so that only three members are elected each year it taks 25 per cent of the stock voted plus one share to elect one director. Moreover, a minority holding 49 per cent of the stock can elect four of the nine directors through cumulative voting where all are elected at once, but can elect only one out of three each year if the terms are staggered, so that it would never have more than three directors on the board.

A situation of this sort existed in Montgomery Ward & Co. at the time of the proxy contest between Louis Wolfson and Sewell Avery in 1955. Montgomery Ward had a board of nine members with staggered terms, electing three each year. Cumulative voting was guaranteed by the state constitution, but, as Wolfson argued, staggering diluted the stockholders' maximum voting strength and therefore conflicted with the guarantee of cumulative voting. The Illinois Supreme Court agreed

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[7] A formula has been devised for discovering the least number of shares a stockholder requires to elect a desired number of directors: x must be greater than $\frac{ac}{b+1}$ where a equals the total number of shares outstanding; c the number of directors it is desired to elect; and b the total number of directors to be elected.

with Wolfson, and declared the statute permitting staggering unconstitutional.[8] Following the court's decision, Montgomery Ward put all nine directors up for election, and Wolfson, through cumulative voting, managed to elect three of the nine.

Other methods of voting. The original common law rule was one vote for each shareholder. When this rule was modified by corporate charters and by statute, giving each shareholder as many votes as the number of shares held by him, difficulties were often experienced by promoters in interesting the small subscriber. In order to avoid this objection, the plan was introduced of giving one vote for each share up to a certain number of shares and then one vote for a group of shares beyond that number, with possibly a maximum number of votes for each shareholder. Thus, the stockholder might have ten votes for the first ten shares, one vote for each ten shares thereafter until a maximum of 100 votes was reached, whereupon voting rights with respect to shares ceased. Any contract of that kind can usually be made in the certificate of incorporation.

Sometimes, to maintain the balance of power between two classes of stock, one class will be given one vote per share and another class several votes per share, or one vote for each several shares held. Thus, in Austin, Nichols & Co., Inc., prior preference stockholders and common stockholders vote as one class, but the prior preference stockholders have one vote for each four shares held whereas the common stockholders have one vote for each share held.

Who is entitled to vote? The right of a stockholder to vote rests on the corporate records. Therefore, only *stockholders of record* possess that right. In case of a dispute between two persons attempting to exercise the right to vote on the same shares, the chairman of the meeting must consult the stock book and be bound by the record, unless a court writ is served on him compelling acceptance of the vote of someone who is not the stockholder of record.

As between a trustee and the beneficiary, the trustee has the right to vote, for he is the stockholder of record. As between pledgor and pledgee of shares, so far as the corporation is concerned the one whose name appears on the books has the right to vote. But as between the parties themselves, the result would depend on the agreement they made. In a case of a simple hypothecation, the pledgor, possessing the legal title, has the right to vote; and if the shares have been transferred by the pledgee to his own name, the pledgor may demand a proxy

[8] Wolfson v. Avery (1955), 6 Ill. (2d) 78, 126 N.E. (2d) 201. On the other hand, the Ohio Supreme Court, in 1956, held that a statute permitting staggered elections and a statute guaranteeing the right of cumulative voting could both stand, saying that the right to cumulative voting did not guarantee the effectiveness of the exercise of the right to elect minority representation on the board (Humphrys v. The Winous Co. (1956), 165 Ohio State 45).

from him. In some states, including New York, this right of the pledgor to a proxy is guaranteed by the statute. However, unless the pledgor obtains this proxy before the meeting, the chairman of the meeting must allow the stockholder of record to vote. A corporation, of course, cannot vote its own shares, but it can vote the shares it owns in other corporations. Where stock is held jointly by two persons, they must agree or their votes will not count.

Closing the stock transfer book. To give the secretary of the corporation time to prepare the list of stockholders of record for the chairman of the meeting, and to avoid any confusion that might result from making transfers on the books at the last minute, the by-laws of a corporation may provide for the closing of the stock transfer book for a reasonable period, usually not exceeding forty days prior to the stockholders' meeting. If this provision is in the by-laws or state statutes, the directors may fix a day for the closing of the books, after which and until after the meeting, the secretary or transfer agent will refuse to record any transfers on the stock book. In small corporations there is no real need for closing the books. Some of the larger corporations are finding that lists of stockholders can be prepared on the day of the meeting without closing the books and without any confusion. Wherever it is possible to do so, it is better not to close the books, for such a practice unduly interferes with the transfer of shares.

A more practical method of handling this problem is permitted in some states. Instead of closing the books, the corporation is permitted to prepare a list of stockholders as of the close of business on a certain date, perhaps ten to 40 days prior to the meeting. That list, by charter or by-law provision, is binding on the corporation and its stockholders. During the interval between the closing date and the meeting transfers are made but are disregarded in the preparation of the list of stockholders entitled to vote.

Voting by proxy. A proxy is a revocable written power of attorney by which a stockholder of record transfers his right to vote without transferring the title, either legal or equitable, to his shares.[9] The word "proxy" is applied not only to the document evidencing the authority to vote for the stockholder, but also to the person to whom the authority is given. At common law, and today usually in religious and similar corporations, a stockholder cannot vote by proxy, but must vote in person. But statutes governing business corporations generally

[9] The statutes usually limit the length of time during which a proxy is valid. In New York State, a proxy may be made for any definite time, but if the time is not specified it expires in eleven months. In Delaware, a proxy cannot be voted upon after three years from its date unless it provides for a longer period. Frequently, the proxy is given for one meeting only, and it will then be good for that meeting and all adjournments thereof.

permit voting by proxy. Even in the absence of a statute, it has been held on the ground of practical convenience that by-laws may provide for it.

In practice, the directors designate a proxy committee, or one acceptable to management is elected at the annual meeting. Very often, officers of the corporation or "dependable" stockholders make up the committee. Their names are printed on the so-called official proxy that is sent out to all stockholders with the notices of the next annual meeting. To be represented at a stockholders' meeting, the stockholder has merely to sign his name on the printed proxy form and to enclose it in a stamped and addressed envelope which is sent by the company with the proxy. The proxy committee votes for the directors whom management itself has nominated. Thus, management usually controls both the selection and election of directors, and because of the apathy of stockholders, vested management or an entrenched minority succeeds in perpetuating its control.[10]

Any opposing interest may form its own proxy committee, send out its own proxy forms and solicit proxies for its own nominees. The opposition can publicize its position and try to persuade those who have already submitted a management proxy to revoke it. A stockholder ordinarily has the right to revoke a proxy at any time. The expense involved in soliciting proxies, however, frequently is a deterrent to organizing an opposition group.[11] Also, those who try to organize the outsiders to defeat the management usually find that the stockholders are reluctant to shift their allegiance.[12]

At a stockholder meeting where there is a contest the final vote usually shows that management, through the proxy committee, wins the election. The result, however, may be different. In the widely publicized proxy contest between Robert Young and the management of the New York Central Railroad Company in 1954, the management was ousted. In the year following that contest 30 proxy battles were waged, and in 6 of them management lost.

Proxy contests often involve legal maneuvers as well as the solicitation of proxies, and many court decisions have been sought on ques-

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[10] Recognizing that corporate management can frequently perpetuate itself in office through its control of the proxy machinery, the Securities and Exchange Commission laid down a procedure to be followed in the nomination and election of directors of the Southern Colorado Power Company immediately after its reorganization. This was done to make effective the redistribution of voting power provided in the simplification plan (SEC Holding Company Act Release No. 4501, 1943). The power of the SEC to do this under Public Utility Holding Company Act of 1935 was referred to at page 44.

[11] Robert Young, in his successful attempt to gain control of the New York Central Railroad Company in 1954, spent more than $1,300,000.

[12] For an account of some of the best-known proxy contests and an analysis of their causes and of the methods used to win stockholders' proxies, see David Karr, *Fight for Control* (New York: Ballantine Books, 1956).

tions of who legally has the right to vote and whether meetings at which elections take place are legally held.[13] Frequently, in proxy fights for control of corporations those who head the opposing fac-

PROXY • THE ____ COMPANY • ANNUAL MEETING
TO BE HELD AT ELEVEN O'CLOCK A.M. (DAYLIGHT SAVING TIME), TUESDAY, APRIL __, 19__
ROOM ____, __ EAST ____ STREET, NEW YORK, N. Y.

THIS PROXY IS SOLICITED ON BEHALF OF THE MANAGEMENT

The undersigned hereby constitutes and appoints J. H. L______, J. S. L______, A______ C. L____, W. H. M______, and L. J. N______, and each of them, as proxies, with full power of substitution, to vote all of the stock of The ____ Company which the undersigned has the power to vote at the Annual Meeting of Stockholders of The ____ Company to be held April __, 19__, in Room ____, __ East ____ Street, New York, N. Y., or at any adjournment thereof, in the transaction of any business which may come before said meeting, as fully and with the same effect as the undersigned might or could do if personally present, and particularly to vote for the election of Directors and as indicated on the reverse side hereof in respect to the matter there specified.

THE SHARES REPRESENTED HEREBY WILL BE VOTED AS DIRECTED BY THIS PROXY, BUT IF NO DIRECTION IS MADE THEY WILL BE VOTED FOR THE PROPOSAL ON THE REVERSE SIDE HEREOF.

Please do not fold, staple or mutilate this card. (Continued, and to be signed on the other side)

(Proxy—continued from other side) 120075

The undersigned instructs said proxies to vote as follows:

Approval of the appointment of A__ A__ & Co. as Auditors for the year 1955... The Directors recommend a vote "FOR".... FOR ☐ AGAINST ☐

The stockholder's signature should be exactly as the name appears below. Persons signing as executors, administrators, trustees, etc., should so indicate.

Dated ______________19__

Stockholder's Name
Street Address
City, State

____
Signature

Proxy That Complies with Securities and Exchange Commission Requirements.

tions are already directors of the corporation; the fight, in other words, is among the directors. In such situations, as well as in fights between management and dissident stockholders, a compromise arrangement is often attempted. Compromises, however, tend to provide only a temporary settlement. They often end in dissension with both sides soliciting proxies for an all-out contest.[14]

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[13] Many other questions arise in proxy contests that must be decided by the courts. For example, the conflict in 1957 between the two factions on the board of directors of Loew's, Inc., resulted in court decisions on the validity of a special election of directors and the validity of a derivative stockholder action.

[14] When a proxy fight was threatened in February, 1957, an agreement was reached between the management of Loew's, Inc., and a group of dissident stockholders to divide the membership of the board equally. However, by July of that year dissension had caused the resignation of several directors, legal actions, and public airing of the grievances of both factions. The 1958 Penn-Texas Corp. battle resulted in the resignation of the president.

Restrictions on solicitations of proxies. Considerable gains were made in preventing the abusive use of proxies when the Securities and Exchange Act of 1934 was passed. Under that Act corporations whose securities are listed on registered exchanges (see page 271) must follow the rules of the Securities and Exchange Commission governing solicitation of proxies. Penalties are imposed for failure to conform. The rules require that a written "proxy statement" be furnished to each person whose proxy is being solicited. If the proxy is solicited on behalf of management, and relates to an annual meeting at which directors are to be elected, the security holder must be furnished in advance of the meeting with an annual report showing the financial position and operations of the company.

The proxy statement must set forth (a) whether it is being solicited on behalf of the management, (b) the nature of the matters to be voted on under the proxy, (c) the rights of dissenting stockholders,[15] (d) whether the person giving the proxy has power to revoke it, and (e) who is bearing the cost of solicitation. When there is to be an election of directors or action on any bonus, profit-sharing, pension, stock purchase, or other remuneration plan, the proxy statement must reveal about each director, nominee, and officer certain information showing the aggregate compensation of each such person from the company and its subsidiaries. The proxy must contain ballot space on which each stockholder can register "Yes" or "No" on the various proposals submitted either by management or individual stockholders.

The proxy rules provide methods by which proposals by stockholders may be brought to the attention of the stockholders. In fact, management may be requested to mail proxies and other communications furnished by stockholders to stockholders who are solicited for proxies by the management. However, a person making such a request must reimburse the corporation for all expenses incurred in connection with such a mailing, whereas the cost of soliciting proxies on behalf of the management is borne by the corporation. The corporation, if it wishes, may supply the stockholder with a list of stockholders instead of mailing the material for him.

Stockholders' meetings—quorum. Stockholders' voting rights must usually be exercised at a regular or special meeting of the stockholders. Regular meetings, generally called annual meetings, are held once a

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[15] Stockholders who dissent from certain lines of action taken at a meeting, such as a sale, lease or exchange of all the corporate property, a change in the nature of the business, and the like, are given statutory remedies in many states. For example, statutes permitting a consolidation or merger of a corporation with the consent of less than all the stockholders generally make provision for the payment to dissenting stockholders of the appraised value of their shares at the time of consolidation. The proxy statement must indicate what the rights of dissenters are under the statute and what the stockholders must do to perfect those rights.

year for the election of directors.[16] Meetings that are not regular are variously termed "special," "general extraordinary," or "called" meetings. Any business may come before a regular meeting, particularly if the notice calling the meeting states the business to be considered. However, if the statute provides, as it sometimes does, that certain transactions can be consummated only "at a special meeting of the stockholders called for that purpose," the business cannot be transacted at a regular meeting. At a special meeting of stockholders, no business other than that specified in the call for the meeting may be considered or transacted unless all the stockholders entitled to vote are present or represented by proxy, and unless all consent to the transaction of the business. Special meetings are called as the need for them arises. To avoid the expense of calling special meetings, management of large corporations usually plans to cover at the annual meeting all questions on which stockholder approval is required.

At any meeting of stockholders a quorum must be present. The share representation required for a quorum is usually designated in the by-laws or the certificate of incorporation, and if that number is not represented, in person or by proxy, the meeting must adjourn to another time. The secretary of the corporation therefore usually follows very closely the return of proxies to be sure that there will be a quorum represented at the meeting. Where necessary, he goes after the larger stockholders to get their proxies, or employs professional proxy-getters. A majority vote of the quorum is usually sufficient to decide an election or any other question, although on important questions, such as an amendment of the charter, increase or decrease of capital stock, and the like, the approval of a two-thirds or three-fourths majority may be necessary because of a statutory or charter requirement.

Increasing interest in stockholders' meetings. Very few stockholders ordinarily attend stockholders' meetings in person. This is due not only to stockholder indifference, but also to the difficulty of arranging a meeting place and time sufficiently convenient to attract many shareholders. Even a decided effort on the part of management to increase stockholder attendance ordinarily results in the presence of only a few hundred stockholders. Although the American Telephone and Telegraph Company has almost 1,500,000 shareowners, the largest attendance at an AT&T stockholder meeting up to April 17, 1957, was 3,000, or .2 of 1 per cent of the stockholders.

The interest of stockholders in corporate affairs is increasing, however, and so is the attention that corporations are giving to their stock-

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16 For forms of notices of annual and special meetings of stockholders, see Lillian Doris and Edith J. Friedman, *Encyclopedia of Corporate Meetings, Minutes, and Resolutions* (Englewood Cliffs, N. J.: Prentice-Hall, Inc., 1958).

holders. To a certain extent, this trend may be attributed to the efforts of the "professional stockholders" who have tried to stimulate interest among small stockholders and to gain recognition of their rights by the corporations.[17] They have attended annual meetings and, in addition to annoying management by their often embarrassing questions, have campaigned for such things as cumulative voting, limitations on officers' salaries, full disclosure of company operations, and more action participation by small stockholders in company affairs.

Managements at first considered the professional stockholders mere nuisances, but many have realized that there is much to be gained by listening to them. As a result, annual reports have been made more attractive and understandable, and annual meetings have been arranged so that more stockholders can attend. Some corporations—General Mills, Inc., and Pepsi-Cola Company, for example—have held informal regional meetings of stockholders in major cities of the country after the regular annual meeting. No corporate business is transacted at a regional meeting, but in every other respect it serves the same purpose as the annual stockholders' meeting. Thus, the affairs of the business are discussed in detail, many questions are asked and answered, and highlights of the annual report are explained.

As long as the present tendency of large corporations to pay more attention to stockholder relations continues, the trend toward increased stockholder interest in annual meetings is likely to continue. However, with wide dispersion of ownership there will probably never be more than a token representation of owners present. The trend, nevertheless, reflects a healthy change in the attitude of directors toward their stockholders. Whereas in the past directors resented having small stockholders question management at the annual meeting, today many are ready to make of the meeting a democratic forum for the stockholders. Also, more and more of the larger corporations are sending their stockholders post-meeting reports of what transpired at the annual meeting. Standard Oil of New Jersey started this practice in 1941 as an experiment in stockholder relations.

Stockholders' rights to information. Stockholders have a right to protect their interest in the corporation by keeping themselves informed as to whether the directors, officers, and agents of the corporation are attending to their duties properly. At reasonable times, and for a proper purpose, they may inspect the books and records of the corporation, including the by-laws, minutes of stockholders' meetings, and the stock register. They may even have the right to inspect the

[17] The best known of these champions of the small stockholders is Lewis D. Gilbert, who began in 1932 buying stock and attending annual meetings of many corporations. By 1956 he was a stockholder in some 600 corporations and attended about 125 annual meetings a year.

books of account and the minutes of the directors' meetings, for the purpose of discovering fraud or mismanagement by the directors. Good cause, however, must be shown before inspection for this purpose will be granted. The statutes of most states provide that stockholders may inspect the records of stockholding and in that way determine who are the stockholders of a corporation to whom they can appeal for co-operative action in defeating oppressive acts of the directors. The statutes of the state in which a corporation is organized must be consulted to determine the limits of the stockholders' rights of inspection.

Stockholders are also usually given a statutory right, under restrictions that will safeguard the interests of the corporation, to demand a balance sheet at least once a year. Such demands are rarely necessary since most corporations with publicly held securities send their stockholders annual reports containing financial statements certified by public accountants. These reports may be carefully prepared, full, and frank accounts of the financial condition and progress of the company, or they may consist merely of a conventional balance sheet and income statement that few of the recipients can understand. The trend is toward publication of comprehensive annual reports that are designed to win the confidence of the stockholders. Some companies communicate information regularly to their stockholders through dividend enclosures, special letters, booklets, and other means.

Companies with securities listed on an exchange must issue annual reports under agreement with the stock exchange.[18] Also, all corporations having securities registered on a national securities exchange, under the Securities Exchange Act of 1934, are required to file an annual report with the exchange and with the Securities and Exchange Commission. The Commission has power to demand quarterly reports. Periodical reports may also be required under the Securities Act of 1933 to keep up to date the information given in the registration statement. These reports are open to public inspection at the exchange on which the security is registered. However, certain portions, which the corporation considers confidential, may be kept from disclosure.

Another source of information for stockholders of corporations whose securities are listed on a national securities exchange is the monthly summary of security transactions and holdings of directors, officers, and large stockholders, published by the Securities and Exchange Commission. These summaries are referred to at page 274.

Directors' obligations. Although authority of corporate management rests ultimately in the stockholders because of their right to elect directors, it is the directors who hold the key position in corporate management and control. Once the directors have been elected, they

[18] See page 50 for requirement of annual reports to stockholders who are solicited for proxies by management.

are not obliged to obey the will of any individual stockholder, no matter how great his stockholdings. However, the legal obligations of the directors to the stockholders have been clearly defined in judicial decisions.

The courts have said that directors must consider conscientiously every question involving the interests of the corporation. They must act in good faith and with reasonable care, and must use that prudence in handling the affairs of the corporation that an ordinarily prudent man would use. They are presumed to know everything concerning corporate affairs that they might have learned from the use of reasonable care and diligence. The directors must use their powers for the benefit of all of the stockholders, and not for the benefit of only a few. They are considered as standing in a fiduciary relation to the stockholders. As trustees for them, the directors may not use their positions of trust and confidence to further their private interests. So long as the directors conduct the business of the corporation in the manner indicated, they remain free from personal liability, although the corporation may suffer losses through the poor judgment of the board.

Whereas the directors' legal obligation is to the stockholders, their social responsibility is much broader. If a large corporation's policies, especially those with regard to prices, wages, working conditions, and dividends, do not contribute toward the social welfare, the directors who make them are at fault. Public censure is the only penalty, but it is one that most corporations today seek to avoid. They are increasingly aware of the dangers to which they expose the entire corporate system if their policies antagonize the public. Many of the larger corporations, mindful of the importance of public approbation, have created public relations staffs to help gain public understanding of the corporation's activities. These same corporations are also usually stockholder-relations minded, and carry on continuous programs to gain the confidence of their stockholders. Although stockholders are a comparatively small part of the public, attention to them plus attention to the public helps to create better understanding of the corporate institution.[19]

Failure to live up to obligations. Should the directors prove to be incompetent to handle the affairs of the corporation, the stockholders' redress is to elect a new board at the next annual election. From the preceding discussion of voting in a corporation it is clear that this remedy may be more apparent than real. If the directors are guilty

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[19] Moreover, many companies have found that good stockholder relations increase the sale of their products. Borden Company helps its sales along by sending letters of welcome to new stockholders and letters of regret, with an offer to continue sending annual reports, to those who have sold their stock. See "Why So Many Stockholders Have a 'Family Feeling' about Borden," *Sales Management*, May 3, 1957, p. 34.

of fraud or bad faith, the stockholders may take legal action to remove them. Furthermore, they may demand that the corporation sue the faithless directors for damages. If the board of directors fails to institute an action, any stockholder may sue on behalf of the corporation and any amounts recovered go to the corporation. Such a suit is called a "derivative stockholder action."

Many such suits have been brought. In recent years, however, several states have passed "security for expenses" laws that discourage such suits. Under these laws, generally, a complaining stockholder who does not own $50,000 in stock or 5 per cent of the outstanding stock of the company must post a bond covering the costs and attorneys' fees of the corporation and the individual defendants. If the suit is unsuccessful, the defendants have recourse to the security. Such restrictive legislation practically deprives the small individual stockholder of his only effective means of making officers and directors of large corporations account for grievous wrongs.[20]

Even in the states that do not require "security for expenses," directors obviously are not haled into court every time they fail to live up to their responsibilities. Many who have ignored the fiduciary relationship that the law imparts to them have undoubtedly not been held accountable by the stockholders because of the trouble involved in prosecuting them. It is easier to sell the stock and let someone else worry about what the directors are doing.

The law has some other ways of influencing directors to live up to their trust. First, it establishes certain rules of conduct for directors who deal personally with the corporation. Second, it imposes liabilities upon directors for certain illegal acts. These liabilities arise under the common law or are set forth in state and Federal statutes.

Contracts with interested directors. A director is not prohibited from doing business with his corporation. It is not unusual, for example, for a corporation to engage a firm of attorneys a member of which is a director of the corporation. Nor is it unusual for a corporation to buy from or sell to another corporation in which a director is interested. The only requirements are that the interested director deal openly with the corporation and that the contract be properly authorized. Dealing openly means that the personally interested director

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[20] For a discussion of "security for expenses" legislation, see "The Future of Corporate Control" by George D. Hornstein, 63 *Harvard Law Review* 476, January 1950. Another development that protects directors and officers from the consequences of stockholder suits is the inclusion of a provision in corporate by-laws to permit a corporation to reimburse directors and officers for costs and expenses incurred in successfully defending a suit brought against them by stockholders on behalf of the corporation. A number of states have passed laws permitting corporations to do this. Of course, if stockholders are successful in a suit, a corporation may not indemnify the directors and officers involved.

acts. For example, a corporation is organized solely to manufacture pianos. The directors think that it would be profitable for the corporation to manufacture and sell sporting goods. They decide to purchase a complete line of bicycles. The venture proves disastrous. If the stockholders have not acquiesced in the directors' action, the directors are personally liable for the losses suffered by the corporation.

5. For fraudulent statements and acts. A director is liable for his fraudulent statements and acts to anyone who was damaged by relying upon them. For example, a director sends a credit agency a statement of the corporation's affairs that he knows to be false. A subscriber to the credit agency's service, acting upon the false statement, extends credit to the corporation, which was hopelessly insolvent when the statement was made. The subscriber may hold the director personally liable.

Criminal liabilities of directors under state laws. The offenses for which directors are made criminally liable by statute in the various states are too numerous to list. A few are:

1. Doing business before receiving proper authorization therefor; doing business as a foreign corporation without a license.
2. Conducting the business of a corporation for an unlawful purpose.
3. Signing or issuing improper certificates of stock.
4. Refusal or failure to make proper entries in corporate books and records; making false entries in books, statements, and reports.
5. Illegal authorization of dividends.
6. Misuse of corporate funds.
7. Making false statements in advertising for the corporation.
8. Engaging in agreements and practices in violation of laws against trusts and monopolies.
9. Violation of laws against political contributions by corporations.
10. Making loans of corporate funds to stockholders, officers, or directors.

Some of the statutes refer expressly to both directors and officers; others merely impose a liability upon officers or upon offenders in general, and directors are liable by implication. Embezzlement, fraud, and larceny are, of course, always punishable under the general statutes dealing with these offenses.

A dissenting director can protect himself against liability by getting his disapproval of illegal acts of the board on record.

Directors' liabilities under Federal laws. Most of the Federal laws that affect the conduct of business, such as tax laws, anti-trust statutes, fair-trade acts, and laws regulating wages and hours, impose civil or criminal liabilities, or both, for violations of the law. Although all of

these statutes do not expressly apply the civil or criminal penalties against directors and officers, there is always the possibility that, under interpretations of the penalty provisions, directors and officers of corporations that have violated the law will be subject to the penalties. Under certain Federal laws, however, civil and criminal liabilities are imposed directly upon directors and officers for failure to comply with the provisions of the laws. The Federal laws concerning security issues and security exchanges, which will be described more fully later,[21] are examples.

Compensation of directors. Students may be surprised to learn, after having been impressed with the responsibilities and liabilities placed upon directors, that directors are not entitled in common law to compensation for services performed in the ordinary duties pertaining to their office. The principle underlying this rule is that directors are trustees for the shareholders and the corporation, and that the law does not imply a promise to pay a trustee for his services as such. This principle, however, does not prevent a corporation from making a contract with a director involving payment of a salary. Nor does it prevent the stockholders from authorizing compensation of directors. The by-laws of many corporations give the directors the right to fix their own salaries along with those of other executives.

Traditionally, however, the directors are given a nominal payment for attending directors' meetings, and are reimbursed for any traveling and other expenses entailed in attending directors' meetings. The nominal payments are frequently $25, $50 or $100, but the trend is toward increasing these fees. Some corporations, in recent years, have adopted the practice of paying directors an annual salary, sometimes of substantial amount, in order to make it worth while for directors to give appropriate attention to the affairs of the company. For example, in 1955, General Mills, Inc., was paying "outside" directors $10,000 a year.

In many corporations some of the directors are also the officers of the corporation. While practically the same rules that govern the compensation of directors apply to officers, the latter are usually active, on-the-job executives who give full time to their duties. They are paid salaries, and in many cases bonuses as well, both of which are usually authorized by the directors.

As we have seen, a director may not vote upon a matter in which he has a personal interest. When directors vote upon salaries of officers, and the directors themselves are the officers, difficult questions frequently arise as to how to authorize the action so that it will be perfectly legal. If there is not a sufficient number of disinterested di-

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[21] See Chapters 11 and 14.

rectors on the board to constitute a majority, the stockholders should vote the compensation or ratify the board's action.

Incentives for becoming a director. A person who accepts the responsibility of acting as a director does not usually do so for the direct compensation that it entails. What, then, are his incentives for becoming a director? Several may be mentioned: (1) He, or members of his family, may own a substantial interest in the company. Membership on the board affords an opportunity to protect the investment and to enhance its value. (2) He may be a banker, lawyer, insurance man, engineer, or other professional who can profit by serving the corporation in his professional capacity or by having his firm do so. Also, he may gain business through association with other members of the board who are influential directors in other companies. (3) He may be wealthy and not interested in monetary returns. Such a person will serve for the sheer pleasure of being useful. (4) He may value the recognition and prestige that association with a successful enterprise affords him. (5) He may expect to profit by the inside knowledge that he will acquire.

Checks against misuse of inside information by directors. The early history of corporation finance shows many instances of abusive practices by directors and officers through manipulation of the company's securities. The Congressional investigation of stock exchange practices made during 1932–1934 [22] shows that even in the twenties and early thirties directors and officers of some corporations were unscrupulously using information that came to them through their corporate positions to aid them in their market activities. This betrayal of fiduciary duties was one of the reasons for the enactment of the Securities Exchange Act of 1934. The Federal Securities Acts [23] have vested in the Securities and Exchange Commission the control over the issuance of and trading in securities that makes a profitable career for the corporation manipulator very difficult today.

The Securities Exchange Act of 1934 and some of the other Federal securities laws permit recovery of any profits realized by officers and directors from transactions in securities of their companies made in a period of six months. Also, officers and directors and principal stockholders must file reports of the amount of their stock ownership for any month in which there has been a change in ownership. The Securities and Exchange Commission publishes a monthly summary of security transactions and holdings on the basis of these reports. Dis-

[22] Summarized in the Report of the Committee on Banking and Currency, Report No. 1455, 73d Congress, 2d Session (1934).

[23] When the term "Federal Securities Acts" is used, it refers generally to the following laws: the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, the Investment Company and Advisers Acts of 1940.

closure, which invites inquiry, has the salutary effect of discouraging manipulative practices. It does not, of course, eliminate them, as is shown by the many suits that have been brought by stockholders for recovery of profits from those who violated the law. Where violation has been proved, the profits have been recovered for the corporation.

Qualifications of directors. We know what is expected of directors and in a general way what their duties are. To match what is required of them, each director should have these individual qualifications: (1) he must be physically fit for the job; (2) possess irreproachable integrity; (3) be able to give time and energy to the duties of directing; (4) be independent and inquiring, which means he should have no ties that he might feel impelled to serve at the expense of the corporation; (5) have knowledge of the business; (6) be courageous and co-operative.

The board as a whole needs more than the sum of these individual characteristics. It should be well-balanced, with men of different ages, different talents and skills, and different viewpoints. It should be revitalized when necessary with new members who will help keep the board always vigorous, alert, and alive. It should be representative of the stockholders and so constituted that it can perform its important function of supervising the executives who manage the business.

None of these qualifications of individual directors or of the board is prescribed by law or common practice. The requirements, if any are set forth in the law or in the corporate charter or by-laws, are usually limited to these: that a director be of legal age; a citizen and a resident of the state of incorporation; and a stockholder.[24] Since the ownership of one share makes a person a stockholder, the stockholding requirement is inconsequential in assuring the owners that directors will act in the interests of all the stockholders. The requirement is frequently met by having directors own a nominal number of shares called "qualifying shares."

Composition of directorates. The individuals who make up the boards of directors of corporations may or may not have the qualifications that have been indicated as desirable. Frequently, there are "outsiders" among the directors who spend little time with the company, but whose names lend prestige and influence to the corporation. This situation is neither all good nor all bad. If the outsider has been chosen for "window dressing," if he takes the "inside" or management directors' word for everything that comes up, or fails to attend directors' meetings, the director has abdicated his responsibilities and his contribution is questionable. On the other hand, if the outsider conscientiously assumes his responsibilities, he may make an invaluable con-

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[24] See Column 7 in Appendix A for examples of statutory qualification requirements.

tribution to the welfare of the enterprise by bringing to the board maturity of judgment, awareness of economic and social trends, and vision. Outsiders, as a rule, are experienced businessmen who hold top executive positions in other corporations.[25]

A common situation, especially in smaller corporations, is a board made up of one dominant person, who represents a powerful financial interest, and a few "yes" men chosen from among the executives.

The most prevalent composition of directorates among large corporations is a combination of salaried executives and outsiders. A few large corporations, particularly in the oil industry, have boards composed entirely of salaried executives. Generally the fault with this type of directorate is that there is really no board of directors to represent the stockholders and to act as a check on management. Also, if the manager-directors have no substantial stockholder interest in the company, they may show more interest in augmenting their own profits from the company through higher salaries and bonuses than in using company earnings for distributions through dividends to the stockholders. Even where this wrong does not exist, the self-contained board may suffer from a lack of objectivity, ingrown thinking, and an attitude of self-sufficiency. To offset this disadvantage, some leading corporations with boards composed largely of staff executives seek the advice of outside consultants.

The democratic process in corporate control. In theory, the corporation is a democratic institution in which the wishes of the majority of the owners of the corporation are expressed through the medium of stockholders' meetings and carried out by elected directors who represent them. In practice, however, the nature of the ownership usually affects the extent to which the board represents the stockholders.[26] In a closely-held family corporation, in which the directors and managers own all of the stock of the corporation, there is, of course, full representation of the stockholders. Furthermore, there is no question of directors avoiding their responsibility to stockholders or hurting anyone but themselves if they breach their duties. In small corporations, those who control the enterprise usually own substantial interests in it, and the wishes of the majority are likely to be expressed and heeded. But in a large, publicly-owned corporation, where the ownership is comprised of many small stockholders, the directors who manage the corporation are frequently not representative of the main body of stock-

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[25] Some outsiders have almost made a profession of being directors. Investment banker Sidney J. Weinberg at one time was a member of the boards of 31 major corporations.

[26] For a discussion of the corporation as a democratic institution, see Percival E. Jackson, "Protecting the Minority Stockholder," *Commercial and Financial Chronicle,* Nov. 30, 1944, p. 2371. This was a lecture delivered as part of a series entitled "Ten Years of the Security and Exchange Commission—A Review and Appraisal" at the New School for Social Research.

holders. It is a noticeable fact in American corporation management that large corporations are usually controlled by people who own less than 50 per cent of the stock. Indeed, the management of a large corporation is usually able to retain control with a comparatively small ownership.[27] Minority control becomes especially serious when the directors do not live up to their fiduciary obligation, and through partisan, negligent, or abusive use of authority operate the corporation for the benefit of the few.

Condition that makes minority control possible. The one condition that contributes perhaps more than any other to the concentration of control of large corporations in boards of directors who represent minority interests is the indifference of individual stockholders. Large stockholders, such as insurance companies, investment trusts, financial institutions, and corporate investors are not "indifferent" stockholders. The blocks of stock they own are voted by their officials.

The majority of the stock of large publicly-owned corporations is usually in the hands of a host of widely scattered small stockholders. They constitute a completely unorganized group that has no desire to assume the responsibility of ownership. Many of them acquire their securities without investigation of values behind them or of the men who control the management. Many are too inexperienced, ignorant, or incompetent to make such investigations, were they willing to do so. The speculators among them intend to sell their shares when they can make a profit on their investment; the investors hold on to their stock so long as it pays satisfactory dividends, and sell the stock when dividends cease. Most small stockholders readily admit their inability to comprehend the problems of corporate management, and show little inclination to learn, even when enlightened boards make an effort to keep their shareholders informed of the company's condition and problems.

Shareholders usually stand aloof from unified action except after disaster has occurred. They form an apathetic group that has little interest in initiating or supporting actions to replace directors at an annual election. In practice, therefore, small individual stockholders are not in a position to contest an election or to find representative candi-

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[27] During the Alton investigation, which began at the close of 1906, E. H. Harriman and other witnesses admitted that to secure absolute control of a railroad it was necessary to own or concentrate only 20 per cent of the stock. During the investigations of the thirties, it was revealed that ownership of 73,000 shares of Chesapeake & Ohio Ry. common stock, which represented not more than 15 per cent of all the outstanding stock, endowed the Van Sweringen interests with control of the railroad.

For discussion and other illustrations of the disparity between the amounts of contributions by stockholders and the degree of control acquired, see "Hearings Before a Subcommittee of the Committee on Judiciary," U.S. Senate, 75th Congress, 3d Session (1938) on S.10 and S.3072 (Federal Licensing of Corporations), p. 422.

dates for membership on the board. When a group of individual stockholders does succeed in selecting and electing new directors, it is usually at the instigation of existing members of the board who desire a change, or through the efforts of certain financial or other interests who are allied with the corporation.

The methods by which minorities secure and retain control of large corporations are discussed below. Some of them, it will be noticed, would be ineffective but for the weakness of individual stockholders.

How minorities often control corporations. Various methods have been used by minorities to gain and keep control of corporate enterprises. The most common methods include:

1. *Proxy committees*. The practice of obtaining stockholder representation at annual stockholders' meetings through solicitation of proxies was explained at pages 47 *et seq*. This mechanism frequently results in perpetuating the control of the corporation in directors who represent a minority financial interest.

2. *Classified voting*. We have already indicated that stock may be divided into different classes, and that one class may be given the sole voting power. Thus, by the purchase of common stock of the Alleghany Corporation for $255,000, control was obtained over $88,000,000 of preferred stock that had no voting rights.[28] Corporations have actually been organized in which one share of stock has the right to vote, and all the other shares are deprived of that right. Founders' stock and management shares, described at page 92, are further examples of minority control through classified shares.

Sometimes, where there are two or more classes of stock, one class has a voting advantage. Thus, in the H. C. Bohack Company, a chain grocery company operating in metropolitan New York City, the majority of the directors are elected by the vote of $150,000 of second preferred stock held by the successors of the original founders, although public investors hold $4,200,000 of prior preferred stock and over 400,000 shares of common stock. Common stockholders can elect two directors, but have no other voting power. When four quarterly dividends are in default on the prior preferred stock, that stock obtains the power to elect one-third of the board, and the common can elect only one director, leaving the second preferred with the right to elect the remaining directors. Sometimes the privilege of electing directors is given to one class of stock temporarily. Very often this right to elect directors is made contingent upon the happening of some event, as explained at page 43.

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[28] See Senate Committee on Interstate Commerce, "Investigation of Railroads, Holding Companies, and Affiliated Companies." Hearings before subcommittee pursuant to S. Res. 71 (74th Congress), Part 10 (Washington: Government Printing Office, 1937), p. 4071.

3. *Voting trusts.* This subject requires a fuller explanation than can be given here. It is therefore treated at page 65.

4. *Stock purchase warrants.* By the advance sale of the right to become a stockholder, the corporation may give the management assurance of remaining in control. This right is evidenced by a warrant or option, explained more fully on page 94, which gives the warrant or option holder the right to purchase stock at a fixed price. With this medium it is possible to check the loss of control. For example, those in control of a corporation may own only a small portion of a large issue of voting stock. Unless they can obtain additional voting shares in sufficient amount to defeat an organized opposition, they are likely to lose control at any time. In order to be in a position to purchase the shares when needed, the managers, at the time of assuming control, will be given warrants to purchase additional shares of voting stock at a fixed price. The corporation always has sufficient unissued stock to meet the demands of warrant holders. Should the management find at any time that outside stockholders are likely to combine to oust them, they need only exercise their warrants and purchase sufficient additional stock to assure their continuity of control.

By issuing stock that does not have the right to subscribe to new issues, the company facilitates the use of stock purchase warrants to obtain control (see page 247). The denial of the inherent right to subscribe to new issues may in itself also help minorities to retain control. Thus, if the corporation is not obliged to offer new issues of securities to its old stockholders, and the management is eager to have additional shares in order to assure control, it may authorize the issuance of additional stock and permit friendly interests to subscribe to as much of the issue as it needs to remain in control. To be sure, the corporation may have to obtain the consent of the old stockholders in case it is necessary to increase the capitalization before issuing additional stock, and the stockholders may withhold their consent if they anticipate that the management is going to use the issue to assure control. Corporations, however, frequently have an authorized issue of stock in excess of the amount outstanding and the purpose under these circumstances can be accomplished without the consent of the stockholders. For a discussion of the stockholder's right to subscribe to new issues of stock, see pages 248–254.

5. *Control transferred to a holding company.* A company that holds the stock of another corporation may be in a position to dictate the policies of the latter corporation. The board of directors of the holding company executes a proxy to one of its officers and instructs him how to vote the stock. If necessary, the directors of the subsidiary are given "qualifying shares," although in some states, including New York, officers of the holding company are "eligible to the office of di-

rector of the subsidiary." In ordinary cases, a majority ownership of a subsidiary company is necessary to insure control, but very frequently, a smaller interest will suffice. Hence, a company may buy considerably less than half of the stock of another company from the directors, secure at the same time the latter's resignations, and thus come into control of the subsidiary.[29] The remaining stock is in the hands of widely scattered small owners who are not interested in control; and through use of the proxy and proxy committee, control is retained by the minority.

The central control afforded by the holding company device was originally used to promote and develop a single field of industry. Unfortunately, in the decade of the twenties, promoters and others perverted the use of the holding company. It became a device for the promotion of security-selling schemes, and for avoiding taxes. The abuse of the holding company plan led to various forms of Federal legislation designed to control holding companies. The Public Utility Holding Company Act of 1935, for example, regulates holding companies in the electric and gas utility fields. This and other legislation is discussed more fully in the chapter relating to holding companies. See Chapter 25.

Voting trusts. A method, known as a voting trust, has been devised for concentrating the control of a company in the hands of a few people. A trustee, or a group of trustees, makes a contract with the stockholders in the form of a voting trust instrument or agreement, providing that any of the stockholders of the company may deposit their stock and become parties to the agreement. Since their stock is transferred on the books of the company to the voting trustees, the latter become the real stockholders and during the period of the agreement vote at the annual elections and at special meetings. Voting trust certificates are given to the stockholders who become entitled to the dividends. When the trust is dissolved, the trustees exchange their stock for the certificates of beneficial interest and the stockholders thereupon become reinstated as the legal owners of the stock, with the right of control.

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[29] An early notable example of control acquired through a holding company was the formation in 1902 of the Chicago, Rock Island and Pacific *Railroad* Company and the acquisition by it of the stock of the operating Chicago, Rock Island and Pacific *Railway* Company, for which collateral trust bonds of the former company were given. The entire story is interesting and is told in W. Z. Ripley, "Railroads, Finance and Organization" (New York: Longmans, Green & Company, 1915), pages 153–155 and pages 527, *et seq.* An outstanding example of more recent years is the organization of the Alleghany Corporation in 1929 by the Van Sweringen interests. The use of the holding company device by the Van Sweringen brothers in acquiring control of a vast network of railroads with a "shoe-string" investment is described in Report No. 1455, 73d Congress, 2d Session (1934), entitled "Stock Exchange Practices."

Voting trusts cannot be used by a number of competing corporations to work out a monopoly. This doctrine was decided many years ago when monopolies were organized through the formation of voting trusts to take over the legal titles to the stock of the several corporations that entered the old Standard Oil trust and the old sugar trust. In fact, it was in connection with these voting trusts that the word "trust" first came to be applied to monopolies. Usually a voting trust must be limited in time, measured by the definite purpose to be accomplished. For example, if the bondholders of a corporation threaten to foreclose the mortgage securing their bonds, they may be induced to forego this right if given control of the corporation till their bonds are paid off. This can be done by creating a voting trust in which the trustees are nominated by the bondholders. In this way the bondholders would control the directorate of the company until their bonds had been paid off. In New York State, under the statutes, a voting trust cannot endure for longer than ten years. Where a voting trust is created for a period beyond the statutory limit, the trust is wholly invalid.

The most common use of the voting trust is in connection with the reorganization of corporations. The period of the voting trust covers the critical time of rehabilitation, during which control of the corporation is turned over to people who can be relied upon to manage it. Continuation of their control is assured by the voting trust arrangement. Voting trusts are also used in industrial organizations as a means of securing continuity of management and policy of the company. Those who manage the corporation are the voting trustees. They may own only a small part of the whole issue. During the period of the trust agreement, with a minority of the stock they are assured of control without investing any further sums in the corporation. Sometimes only part of the securities, but always sufficient to assure control, are deposited under the voting trust agreement in exchange for voting trust certificates. In that case the shares not deposited would be transferred on the books of the corporation in the regular way and the voting trust certificates would be transferred on the books of the voting trustees. The market price of the securities not deposited is generally the market price of the voting trust certificates, although occasionally securities not deposited sell above or below the voting trust certificates.

Treatment of voting trusts under Federal acts. Voting trust certificates are included in the definition of securities under the Securities Act of 1933 and are subject to the Act. Similarly, if the voting trust certificates or the deposited stock represented by them is listed on a national securities exchange (see page 271), they are subject to the Securities Exchange Act of 1934.

The Securities and Exchange Commission, in administering the Public Utility Holding Company Act of 1935, has sanctioned the use

of voting trusts in reorganizations of companies subject to the Act, in cases where this device has appeared to be in the interest of the public, investors, and consumers. Thus, in the reorganization of Great Lakes Utilities Company, it approved the voting trust even though the device tended to complicate the corporate structure of the holding company system. But the Investment Companies Act of 1940, which applies to investment corporations, prohibits public offerings of voting trust certificates by use of mails or means of interstate commerce.

Any plan of reorganization of corporations under Chapter X of the Bankruptcy Act may provide for vesting control of the reorganized corporation in a voting trust, but the appointment of the voting trustees must be equitable, compatible with the interests of creditors and stockholders, and consistent with public policy. The statute requires the judge to pass upon the qualifications of the voting trustees as a condition of confirmation of a plan.

Weaknesses in the corporate management system. It is obvious from the discussion thus far that there are weaknesses inherent in the management and control phases of the corporate device. The weaknesses may be summed up as growing out of the separation of ownership from control. The number of small individual owners of corporate securities has increased steadily in the twentieth century, with the little stockholders coming from all walks of life in the states, cities and rural areas of the country. In many of the larger corporations they represent a majority of the owners of the enterprise. As indirect owners of wealth, the stockholders have neither the responsibility nor the power associated with direct ownership of wealth. Advantages and disadvantages can be claimed for this situation, both to the individual and to society. For example, the individual is free of the burden of managing the enterprise, but he is also deprived of the satisfaction and personal growth that comes from meeting the challenge of management successfully. He can, if he owns listed securities, determine quickly the value of his investment, but that value in no way reflects his ability or character. Society may be better off because the extension of corporate ownership has made possible the modern corporation with its large scale production methods, but no one would claim that large scale corporate enterprise is an unmixed blessing.

Stockholders of large corporations, we have seen, have no adequate control over the businesses in which they invest their funds. The reasons have already been explained (see page 62). Some of these reasons reflect faults of the stockholders themselves; others indicate faults of the organizers and managers of the enterprise. The social implication here is that the system is prone to place power in a small group of individuals who sometimes use that power selfishly, thus depriving the investor group of income and security essential to their well-being.

Some of the administrative abuses of unscrupulous boards have already been referred to; for example, misuse of inside information by individual directors; voting of excessive salaries, bonuses, and pensions to directors and officers; and failure to give the stockholders full, frank, and clear reports of the affairs of the company.

Remedies of weaknesses in the corporate management system. We shall not treat here the remedies for social weaknesses resulting from the concentration of economic power in corporate enterprises.[30] Our concern here is principally with the remedies against abusive use of power by directors that sometimes grows out of the separation of ownership from control. The most effective remedies have come through Congressional legislation. Some of them have been mentioned; for example, the proxy rules of the Securities and Exchange Commission and the restrictions on the issuance of non-voting stock in some of the Federal laws. Other Federal legislation could be mentioned. For example, the Investment Company Act of 1940 protects minority stockholders in investment corporations by prohibiting the issuance of non-voting stock, restricting stock to one class of preferred and one of common, prohibiting voting trust certificates, requiring independent directors, and imposing other restrictions on control devices.

Beyond Federal legislation, little progress has been made toward protecting minority stockholders (or the majority against their own indifference), principally because it is difficult to effect remedies. The following examples of suggested remedies illustrate the obstacles: (1) Make cumulative voting mandatory to enable active minorities to obtain representation on the board. This would involve amendment of the various state corporation laws. We have already indicated the reluctance of the state to lose revenue by discouraging incorporation under their laws through harsh statutory provisions. (2) Make it easier for stockholders to question management at annual stockholders' meetings. This could be done by requiring the corporation to have an independent and impartial chairman presiding, rather than a director or officer, and by compelling the directors to be present for questioning. This, too, would call for amendment of the various state corporation laws. (3) Get banks, brokerage, and investment houses that sell securities to the public to favor directorates with more active and diligent representation of the stockholders. This would mean getting the financial institutions to work with the investors rather than with management as they now do. Obviously, the incentive is lacking. It may come, however, when the alternatives to such action force it.

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[30] See Chapter 21.

Research Question

Relate the history of the 1957 conflict between two factions of the board of directors of Loew's, Inc.

Problem

A group headed by Mr. Patrick owns $50,000 worth of common stock out of a total of $300,000 authorized and outstanding common stock. Par value is $50 a share. Mr. Patrick's group also owns all of the preferred stock. This stock elects two of the 11 directors if six quarterly dividends have been passed. If the cumulative method of voting is used and seven quarterly preferred dividends have been passed, how many directors can Mr. Patrick's group elect?

CHAPTER 5

Corporate Stock

Definitions. The subject of corporate stock will be more easily understood if certain terms that are frequently confused are clarified at the outset. As each of the terms is defined, its meaning will be illustrated by reference to the abbreviated balance sheet on page 71.

Stock or *capital stock* is the aggregate ownership interest of a business corporation. It is reflected in a capital stock account, which usually shows the dollar value of payments made to the corporation for the individual ownership interests. These ownership interests refer to ownership of the corporation, not of the corporate assets; the corporation owns the assets.[1] Stock, or capital stock, is divided into identical units, or groups of identical units, called shares. The shares are represented by written instruments called *certificates of stock*. Each stockholder is entitled to a certificate showing the ownership of shares. An illustration of a certificate of stock is shown at page 97. In the balance sheet at page 71, the capital stock is the sum of items 16 and 17, or $139,878,500.

Capital is the actual wealth or total assets of the corporation in money, tangible property such as a factory, or intangible property such as goodwill.[2] It is the total investment in the enterprise. Sometimes the word "capital" is used in the sense of "net capital" or "net worth," meaning total assets minus liabilities. In that case, the capital includes the consideration received for issued capital stock plus gains or profits from the use and investment of the capital that have not

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[1] For an instructive analysis of the true nature of capital stock, see the prevailing and dissenting opinions in the well-known stock dividend case, Eisner v. Macomber, (1920) 252 U.S. 189, 40 S. Ct. 189.

[2] The word "capital" is used in this discussion, not in the theoretical sense in which it is used in discussions of economic theory, nor in the legalistic sense, but in the sense in which it is employed in ordinary business transactions.

ABBREVIATED BALANCE SHEET

Current Assets:	
1. Cash	$ 8,085,621
2. Accounts and notes receivable	35,164,513
3. Inventories	50,938,396
4. Marketable securities	483,614
5. U.S. Government securities	19,668,120
Total current assets	$114,340,264
Fixed Assets:	
6. Property—less depreciation	$304,205,071
Other Assets:	
7. Investments in and advances to affiliated companies	$ 5,106,553
8. Trustees' account	4,990,396
9. Contingent and insurance fund assets	2,228,921
10. Stock, securities, etc.	5,149,554
	$ 17,475,424
11. Deferred charges and prepaid expenses	$ 859,336
Total	$436,880,095
Current Liabilities:	
12. Notes payable	$ 1,502,000
13. Accounts payable, etc.	23,777,969
14. Interest accrued	1,863,104
Total current liabilities	$ 27,143,073
Long-term Debt:	
15. Bonds	$156,611,612
Capital Stock and Surplus:	
Capital Stock:	
16. First Preferred	$ 57,408,000
17. Common Stock	82,470,500
Surplus:	
18. Reserve for plant expansion	9,196,235
19. Capital Surplus	10,050,675
20. Earned Surplus	94,000,000
	$253,125,410
Total	$436,880,095

been distributed to the stockholders, or *less* losses that have resulted from the use of the capital. According to the first definition, the capital of the corporation whose balance sheet is given is $436,880,095. Its net capital is that sum less the sum of items 12, 13, 14 and 15,[3] or $253,125,410. This figure is also arrived at by taking the sum of items 16, 17, 18, 19, and 20.

With the terms "capital stock" and "capital" explained, we may now point out that the word "stock" is sometimes used loosely, especially by the courts. It has been used to mean capital stock, capital, the shares of capital stock in the hands of individual stockholders, or the certificates issued by the company to the stockholders. In this book, stock and capital stock are used to indicate the aggregate ownership of the corporation as reflected in the capital stock account.

Capitalization is sometimes used to indicate the total amount of securities outstanding in the form of capital stock and long-term bonds. Under this definition, in the abbreviated balance sheet, the capitalization is the sum of items 15, 16, and 17, or $296,490,112.

For practical purposes[4] capitalization sometimes means the total accounting value of all the capital regularly employed in the business. This capital is represented by the capital stock, surplus, and funded or long-term debt. Thus, capitalization comprises (1) ownership capital, which includes capital stock and surplus in whatever form it may appear,[5] and (2) borrowed capital, which consists of bonds or similar evidences of long-term debt. Under this definition, the capitalization in the abbreviated balance sheet is the sum of items 15, 16, 17, 18, 19 and 20, or $409,737,022.

Capital structure, or financial structure, as it is sometimes called, refers to the make-up of the capitalization; that is, whether it consists of a single class of stock, several classes of stock with different characteristics, various issues of bonds, a large or small surplus, and the

[3] In analyzing a balance sheet, all fictitious assets such as "bond discount" must be eliminated. As to reserves, good judgment must be used to determine the purpose of each reserve. A reserve for depreciation, or amortization reserve, as it is sometimes called, should be treated as a deduction from the value of the fixed assets, as in item 6 of the balance sheet at page 71. A reserve for the payment of Federal income taxes should be treated as a current liability. A reserve for plant expansion, such as item 18, should be treated as a part of the surplus, and therefore should not be subtracted from the assets in determining "net worth."

[4] It is often necessary, for example, to compare the funded debt with the total capitalization. If the surplus represents the bulk of the stockholders' interest in the business, it would be misleading to exclude surplus from total capitalization.

[5] The various forms of surplus will be explained in detail in Chapter 19. Here it is sufficient to point out that "earned surplus" is earnings accumulated in the business; "capital surplus" is surplus arising from other sources. One form of capital surplus is "paid-in surplus," which will be explained later in this chapter in connection with the no-par stock.

like. Equity securities [6] and long-term debt securities are usually the principal parts of a company's capital structure. To enable the corporation to raise permanent capital with a minimum of effort and cost when it is needed, these elements must be kept flexible. Since flexibility is affected by the terms of the securities that are outstanding, in the explanation of corporate stock that follows, attention is given to the effect of the form or characteristics of stock on flexibility of capital structure.

Authorized, issued, treasury, and outstanding stock. Authorized capital stock is the amount of stock that a corporation is empowered to issue by its certificate of incorporation. It does not change from time to time, unless, of course, the certificate of incorporation is amended.

Authorized stock is divided into unissued and issued stock, which terms explain themselves. Before any stock is sold, all the authorized stock is unissued. As it is sold and paid for, the company issues it.[7]

When stock has been issued and is in the hands of a stockholder, it is said to be outstanding. Sometimes a corporation will obtain, by purchase or gift, some of its own stock. Such stock is called "treasury stock."

These definitions may be summarized as follows:

$$\text{Authorized stock}\begin{cases}\text{Issued}\left\{\begin{matrix}\text{Part Paid}\\ \text{Full Paid}\end{matrix}\right\}\begin{cases}\text{Outstanding}\\ \text{Treasury}\end{cases}\\ \text{Unissued}\end{cases}$$

Classification of stock. The most usual classification of capital stock is that which divides it into common and preferred. In England such shares are generally called "ordinary" and "preference" shares.

A company usually divides its stock into more than one class in order to attract capital. By classifying the shares it can vary the risks of the owners and thus raise funds from a wider circle of investors. These variations concern either the amount of income or stability of income of the stockholder, his right of control, the risk he runs of the ultimate loss of his investment, the time during which he will be a stockholder, or his right to exchange his stock for other forms of stock or securities. The principal variations will be discussed in this chapter.

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[6] In financial parlance, equity is the interest of stockholders as measured by capital and surplus. The term is also used to refer to the unlimited interest of common stockholders. Common shares are often called "equities."

[7] See page 98 for issuance of stock certificate for part-paid stock.

Common stock. All corporations have common stock;[8] some corporations have common and preferred stock. The outstanding characteristic of common stock is that its holders have an unlimited interest in the corporate profits and assets. They share in dividends after the preferred stockholders' rights to dividends have been satisfied, and they participate in the distribution of assets after all prior claims have been met. Since the common stockholders are the last to be paid out of the proceeds of dissolution of a corporation, their equity acts as a cushion in the event that the assets of the corporation shrink in value. They have voting rights that enable them to participate in the management, as explained in the previous chapter.

Preferred stock. Preferred stocks came into existence with the railroad reorganizations of the nineteenth century and were used to give investors something less speculative. The preferred stockholder usually has the rights of a common stockholder except that he is to receive a share of the profits annually before any profits are distributed to the common stockholders. Also, preferred stock usually has the right to share in the distribution of assets upon dissolution before the common stock. Thus, the position of preferred stock relative to earnings and assets is stronger than that of comon stock but not as strong as that of bonds. Gradually, various special preferences were given to this class of stock, or certain special limitations were placed upon it. As a result, there are today many different kinds of preferred stock. The most important of the special preferences and limitations will be explained in the further discussion of preferred stock that follows.

As in the case of common stock, preferred stock has the right of participation in the management through its power to vote, unless that right is taken away by contract. As was explained in the preceding chapter, it is usually the preferred stock that is made non-voting, or given vetoing rights on certain questions or contingent voting rights under certain circumstances.

Classified common and preferred stock. Formerly, the class of stock with special rights was known as preferred stock and the class with ordinary rights as common. However, during the 1920's, the practice developed of denying voting power to a class of stock without giving that class much preference. In many instances, when there were two classes of stock created that were quite similar, one with and the other without voting power, those classes of stock were named Class A, Class B, and so on. Later variations of this method of classifying stock

[8] Occasionally, an exception arises through changes in capital structure. Great Northern Railway had only preferred stock outstanding from 1890 until 1954. In its early years, the company had both common and preferred stock, but in 1890 the company re-acquired the outstanding common stock. After that there were increases in authorized preferred stock, but no common stock was issued until 1954, when the preferred stock was reclassified into no par common.

show a division of the preferred and common stock into Class A, B, and so on, for each.

The classification of comomn stock into Class A and Class B came about largely to meet the demands of investors for a share in the increased profits enjoyed by corporations during and following World War I. From 1925 to 1930, when common stocks were again in demand because of large earnings, classified common stock was provided for by many new corporations and by corporations that were changing their financial structure. Usually the Class A common stock was promised dividends at a liberal rate and was made participating in the profits along with Class B common after a definite rate had been paid to the Class B stockholders. Almost invariably the voting power in a corporation with classified common stock rested with the Class B stockholders, Class A being non-voting except possibly upon default in dividend payments.

A decline in the use of classified commou stock began in the 1930's when little new financing could be accomplished with any kind of stock. Its use has not returned, principally because one of the purposes of classified common was to deprive one of the classes of voting power, and, as was pointed out at page 44, non-voting stock has been discouraged by various government agencies and the New York Stock Exchange. A few companies still have classified common stock outstanding that was issued during the 1920's. For example, General Aniline & Film Corporation has Common A and Common B outstanding, but both classes have equal voting power. Most of the companies that had classified common stock substituted a single issue of common for them in later financing.

The classification of preferred stock has become usual through the issuance of such stock in series. This method of issuing preferred stock will be explained immediately after the discussion of preferred stock is completed.

Participating and non-participating preferred stock. The most usual privilege attached to preferred stock is the right to receive a fixed or stated rate of dividends before any dividend is declared on common stock. This stated preferred dividend rate is usually expressed as so many dollars per share or as a percentage; thus, $5 preferred stock or 7% preferred stock. However, the terms of the contract under which the preferred stock is issued may give the stockholders a right to dividends beyond the fixed rate. In that case the stock is said to be *participating,* because it participates along with the common stock in distributions of earnings. The arrangement for participation is purely contractual; that is, the different classes of stockholders, in accepting their stock, make a contract with the corporation and with one another to abide by the provisions of the certificate of incorporation.

These provisions, set forth in the certificate of incorporation, may be made in as many different ways as the founder of a corporation may imagine. The following examples are typical participating arrangements: Chicago & Northwestern Ry.: preferred 5 per cent, then common $5, then preferred shares equally with common to the extent of $1 a share in any one year. Consolidated Chemical Industries, Inc.: preferred $1.50 per share; common $1.50 per share; common and preferred share equally in the remainder.

A preferred stock that is *non-participating* is entitled only to the fixed or stated rate of dividends, and to nothing more. A company with two kinds of preferred stock might have one class participating and the other non-participating.

Where two classes of stock are mentioned in a certificate of incorporation and one is called common and the other merely "7 per cent preferred," some courts will decide that the preferred will be "participating." This means that the preferred is to be paid 7 per cent before the common shares; then, if profits are left, the common will be given 7 per cent; and if there are any profits left after that, the two classes will be regarded as one class for any further distribution of profits. The reasoning on which this principle is based is that the preferred stockholders yield nothing in compensation for the benefits that they receive; but they hold all the rights of the common shareholders in addition to their preferential rights. Other courts will hold that the preferred will be "non-participating"; that is, that the common stockholders are entitled to all the earnings after the dividend rights of the preferred stockholders have been safeguarded. The reasoning on which this principle is based is that in receiving the greater security for his preferential right, the preferred stockholder agrees by implication to accept such right in lieu of equal participation.

Cumulative and non-cumulative preferred stock. Dividends upon preferred stock may be cumulative or non-cumulative. If the preferred stock is described as cumulative, the effect is that if the specified rate upon the preferred stock is not paid in one year, there will be an arrearage that must be made up in subsequent years before any dividends may be declared on the common stock. Ordinarily, if nothing is said on this subject in the certificate of incorporation, the law will hold the stock to be cumulative. Where preferred is cumulative and dividends are not paid, the arrearages, when made up, ordinarily do not bear interest. Nor do the arrearages in cumulative dividends become a liability of the corporation.

If the preferred stock is described as non-cumulative and dividends have not been declared upon the stock, the dividends omitted in any year do not accumulate and need not be made up, even though earned

for the year in which the dividend has been omitted.[9] In other words, since the Wabash Railway case, earnings can be applied in any year by the directors to necessary corporate purposes, such as an expansion program, instead of to dividends on the non-cumulative preferred stock, and the stockholders can do nothing about it, provided the directors have acted in good faith. This being the rule, preferences in dividends are subject to manipulation. We may assume a case where the directors hold common stock amounting to $100,000 and the outsiders hold $100,000 of 8 per cent preferred stock. Let us suppose, further, that a fair system of accounting would reveal a profit of $8,000 a year. If this were divided properly, the preferred stock would get $8,000 and the common stock would get nothing. By a form of manipulation known even to the novice in accounting, the directors might show on their books no profits in one year, and, by reversing the process, a profit of $16,000 in the alternate years. Thus, every other year the preferred would get its $8,000 and at the same time the common would also get $8,000. Each class would average $4,000 a year, whereas the preferred should get $8,000 each year and the common nothing.

To prevent this form of manipulation, preferred stock is usually made cumulative. Sometimes stock is issued as non-cumulative and becomes cumulative after the lapse of a few years. This gives the corporation time to get on its feet before it is subject to the handicap of preferred dividends in arrears. An example is Hudson River Day Line $6 cumulative preferred, issued in 1936 and cumulative from January 1, 1945. To prevent a burdensome accumulation of arrears, a limitation may be placed upon the cumulative feature. Thus, the preferred stock of Alabama Great Southern R.R. Co. is not entitled to any payment of arrears exceeding six years.

If arrearages of cumulative dividends reach a large amount, as they did in many corporations during the depression of the thirties, they become a burden to the company in connection with future plans for

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[9] This conclusion of the Supreme Court in Barclay v. Wabash Railway (1930) is contrary to the holdings of several courts in earlier decisions. These earlier cases held that the directors could not withhold dividends on non-cumulative stock in years when the corporation had earned sufficient to pay dividends, or proceed to pay dividends on the common stock in following years before making up the dividend on the preferred stock that had been earned and omitted. See Bassett v. U. S. Cast Iron Pipe & Foundry Co., (1908) 74 N. J. Eq. 668, 70 Atl. 929, affd. (1909) 75 N. J. Eq. 539, 43 Atl. 514; Day v. U. S. Cast Iron Pipe & Foundry Co., (1924) 94 N. J. Eq. 389, 123 Atl. 546, affd. on appeal 96 N. J. Eq. 738; Collins v. Portland Electric Power Co., (1925) 7 F. (2d) 221, affd. 12 F. (2d) 671. The question of whether there is any control over the board's power to manipulate its dividends so that common stock may profit at the expense of the non-cumulative preferred stockholders is still vigorously debated.

financing, and in general are finally eliminated through some plan of readjustment. The reader may care to investigate the attempts to clear up arrearages on the preferred stock of the American Hide and Leather Co., on which over 140 per cent was due. The capitalization was finally readjusted in 1925 and the accumulations wiped out. Another accumulation of dividends on American Hide and Leather preferred stock of $217.75 a share was wiped out in the readjustment plan of 1935. In 1939, and again in 1955, an accrual of unpaid dividends was cleared up.

Preference in regard to assets. We have described the usual variations in stock that affect control and income; now let us briefly consider variations in risk. As will be shown later in this book, stockholders are the risk-bearers; that is, they are the last people to be paid out of the proceeds of the dissolution of a corporation. But they may agree among themselves to share the risks in different degrees. Thus, preferred stock may be made preferred as to assets as well as to dividends. In that case, on liquidation of the company the holders of such stock will be paid back a certain amount for each share out of what is left after satisfying the creditors, before the other class receives anything. Sometimes this provision is made "non-participating," by which is meant that although the preferred stock will get the value to which it is entitled in liquidation as stipulated in the certificate of incorporation before the common shares get anything, if the company does have abundant assets the common stockholders will not only get back their capital, but all the profits as well.

Redeemable or callable preferred stock. Frequently, preferred stock is made redeemable, or callable. This means that the corporation has the right to demand that the stockholders surrender their stock to the corporation and receive cash in payment for it. Common stock never is redeemable in the sense in which redemption is used here.[10]

The option to redeem always belongs to the corporation, because the redemption can take place only to the extent that the corporation has a surplus. Thus, the original capital is not returned to the stockholders, but they are paid from a surplus representing profits retained in the business, or from some other form of surplus, when they turn in their stock. The shares to be redeemed are frequently

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[10] Repurchase provisions in the contracts under which common stock is sometimes issued resemble a redemption provision. For example, management investment companies (see page 215) of the open-end type sometimes issue shares which the company is obligated to repurchase at any time, at the option of the holder, at approximately their asset value. Another example occurs in the case of close corporations, which usually issue only common stock. The corporation may restrict the transfer of the shares by providing that a shareholder who desires to sell his stock must give the corporation the option of purchasing it. The courts are inclined to uphold such provisions generally as contracts between the company and the stockholders, so long as the rights of innocent third parties are not injured.

drawn by lot, though in some instances the redemption is pro rata; that is, an equal proportion of the shares of each stockholder is called. In most cases, stock can be, and often is, bought in the open market at not more than the redemption price. The redemption price is usually above par and includes all dividends in arrears. Notice of redemption is ordinarily required, from ten days to several months being not unusual, and the actual date of redemption is generally required to be one of the regular dividend dates.

Where there is no provision in the charter for redemption, the company may attempt the same thing by buying in its stock. Such purchases may be made by separate negotiation, by purchase through a broker on one of the stock exchanges, or through a general offer to the stockholders to purchase shares of stock from them. Such purchase is usually sanctioned by the courts, provided the assets used for that purpose are not needed for taking care of the present creditors.

Whether stock that has been redeemed may be reissued, depends on the charter and on the local statutes. Frequently, the charter provides that redeemed stock shall be canceled.

Purpose and effect of redemption. Most of the preferred stocks issued in recent years have been made redeemable principally to afford the company an opportunity to eliminate this class of stock, with its prior right to fixed dividends, when the financial condition of the company warrants it. The inclusion of the redeemable feature makes it possible for the corporation to call the stock if changes in the prosperity of the enterprise or in interest rates make the dividend rate on the preferred unnecessarily high, or if some provision of the stock interferes with future financing.[11]

Redemption of an issue of preferred stock increases the earnings for the common stock and improves its dividend prospects. It also strengthens financial structure, and adds flexibility for future financing.

Where several classes of stock are outstanding and one with voting power is redeemable, the corporation may wipe out its voice in the control by redeeming it.[12]

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[11] The notice of Gaylord Container Corporation calling for redemption of its 5½ per cent cumulative convertible preferred contained this statement: "The provisions in the charter covering the fiscal activities of the Company set up in connection with the preferred stock issue contain restrictions and limitations entirely out of keeping with the remaining portion of the issue presently outstanding and would be, financially speaking, an unnecessary and serious obstacle to the future company financing and management planning. In order, therefore, to remove these restrictions and to have the further advantage of simplifying the Corporation's stock structure to one kind of stock, the board of directors has decided to call the outstanding preferred stock for redemption."

[12] See, for example, the story of the quarrel between Hill and Harriman in the Northern Pacific corner of 1901, J. G. Pyle, *The Life of James J. Hill* (New York: Doubleday, Doran & Co., 1917), and J. G. Kennan, *E. H. Harriman* (Boston: Houghton Mifflin Company, 1922).

The redemption feature may keep the price of a stock down, or even pull it down. Investors are not willing to pay much above the redemption price if they are likely to get the redemption price back shortly after their purchase. For example, in July of 1956, the 5 per cent Hercules Powder Co. preferred ($100 par) sold at 124. At the same time, the Oxford Paper Company 5 per cent preferred (par $100) sold at 100. Although these stocks were of approximately equal quality and both paid $5 per year, the Oxford preferred was selling for less. The reason for the discrepancy was that the Oxford preferred was redeemable at 100, and people were unwilling to put $124 into a share of preferred that could be called for redemption at 100.

Sinking fund for redemption of preferred stock. A company that wants to reduce gradually the amount of redeemable preferred stock outstanding, and thus accomplish the purposes just described, might agree to provide for regular sinking fund payments for redemption purposes. In that case the sinking fund provision would call for setting aside a specified sum from profits annually before dividends are paid on the common stock, or before dividends can be paid on the common stock in excess of a given rate. Usually the annual payment required is a certain percentage of the amount of preferred stock outstanding, or a certain percentage of the net income, or a fixed minimum amount in dollars.

Usually, the sinking fund does not exist as a fund to be used only when sufficient sums have been accumulated to redeem the entire issue. Instead, the amount required to be put aside annually is immediately applied to the redemption of the preferred stock.

Convertible preferred stock. Convertible preferred stock is stock that is convertible into some other form of security. Usually, conversion is at the option of the stockholder and permits the conversion of senior securities into junior securities of the same company. Thus, convertible preferred stock is ordinarily convertible into common stock.

Stock cannot be made convertible into bonds except at the option of the company; otherwise, stockholders would convert their stock into bonds when a company became insolvent and thus would get an advantage over creditors. A rule contrary to the one given would permit the stockholders to have their cake after eating it.

Where conversion of stock into bonds at the option of the company is permitted, it is limited to an amount equal to the surplus or undivided profits of the company. This prevents the breach of a well-known rule of corporation law, that the corporation cannot directly or indirectly give back to the stockholders any of their contributed capital except through an amendment of the certificate of incorporation.

Conversion rate or price. The conversion provisions in the articles of incorporation express the rate at which the corporation will exchange the convertible shares, upon exercise of the conversion privilege, in terms of the number of shares into which the security is convertible (generally called the "conversion rate"), or the price per share at which the new shares are issuable (generally called the "conversion price"). In the case of industrial convertible issues, the rate is usually expressed in terms of so many shares of common stock for each share of convertible preferred. For example, the conversion rate of the $5 convertible prior preferred stock of the American Zinc Lead & Smelting Co. is four shares of common stock for each share of prior preferred stock. The conversion privilege of the 5 per cent non-cumulative preferred stock of the Hudson & Manhattan R. R. Co. is expressed not as a certain number of common shares for each share of preferred stock, but as one share of $100 par preferred stock convertible into one share of $100 par common at 110. This means that to receive ten shares of common, the holder of preferred stock must give up eleven of his shares.

Purpose and effect of conversion feature. The conversion feature adds speculative interest to a preferred stock and may make it possible to sell an issue that otherwise would not appeal to buyers.[13] This speculative interest arises from the possibility that the price of the common stock into which the preferred is convertible may at some time in the future rise sufficiently to make the price of the preferred rise.

In rare instances, when an issue of common stock cannot be marketed but an issue of convertible preferred can, the company so fixes the conversion rate that it is at once profitable for the stockholders to convert into common. Conversion takes place fairly quickly and the company strengthens its capitalization with the greater amount of common stock.

If a class of stock is redeemable, as well as convertible, and the value of the stock issuable upon conversion is greater than the redemption price, a company may issue calls for redemption mainly to bring about conversion. Its purpose is usually to simplify its capital struc-

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[13] A wide demand for convertible preferred stock developed during the prosperous years 1925–1929, largely on account of the phenomenal rise in the values of common stock during that period. Moody's *Manual of Industrials for 1938* listed about five hundred industrial convertible stock issues, somewhat less than the number that appeared in its 1930 compilation. The 1949 compilation listed about four hundred and twenty-five industrial convertible stock issues. It should be pointed out, however, that the total listings of preferred issues on the New York Stock Exchange was smaller in 1949 than in 1938, due to the trend toward simplification of capital structures and away from classes of non-voting stock. This trend has continued, as the 1956 compilation listed only about 380 convertible industrials.

ture. Thus, in 1946 Monsanto Chemical issued a Series A preferred stock, convertible into two shares of common, and the company's directors announced at that time that they intended to induce conversion when practicable. Twice during 1948, when the directors considered market conditions propitious, calls were issued for 64,000 and 120,000 shares respectively. In both cases essentially all the holders elected to convert, and only 626 shares of the preference stock were redeemed. Similarly, if a class of stock is redeemable, a company may in effect exercise the option of conversion by calling the stock for redemption and then offering in place of cash another class of stock. Some convertible stock may be reissued after conversion; for example, El Paso Natural Gas convertible preferred, second series.

Where one class of stock is convertible into another class, and one or the other has limited voting powers, a conversion of one class into the other will affect the voting control of the company.

An example of the value of the conversion privilege to the security holder is found in the Beatrice Foods Co., which has a 4½ per cent cumulative preferred and a 3⅜ per cent cumulative convertible preferred stock. The provisions of both issues are about the same except for the conversion feature. In June, 1957, the 4½ per cent preferred stock sold at 90, to yield 5 per cent, whereas the 3⅜ per cent issue sold at 126, to yield only 2.68 per cent. The extreme difference in yield can be explained by the added value of the conversion privilege. The 3⅜ per cent preferred was convertible into common at the ratio of 3.89 shares of common for each share of preferred, and at the time the common sold at 34.

Limiting the conversion period. An increase in the earnings of the corporation, which will be reflected in the market price of its common stock, will cause many of the convertible security holders to exercise their privilege. If the corporation wishes to be able to force a conversion, which it is likely to desire when the earnings of the corporation are causing the value of the common stock to rise out of all proportion with the "conversion rate" or "conversion price" as originally worked out, it may make the convertible stock redeemable at a fixed price at any time upon a certain number of days' notice. For example, the General Cable Corporation 4 per cent convertible preferred stock is callable at any time on 30 days' notice at 51½ and dividends. The conversion privilege on redeemable stock usually extends to any time on or before the redemption date.

Another method of limiting the time during which conversion may take place is to fix a final date for the exercise of the conversion privilege.

Some issues of convertible stock have provided different conversion rates for different conversion periods, giving the first period the most

favorable conversion price, and thus encouraging early exercise of the conversion privilege. Or an issue may be convertible at varying rates for proportions of stock converted. For example, Sunray-Midcontinental Oil's 5½ per cent cumulative convertible second preferred, series of 1955, is convertible into common at $28.75 per share until one-third has been converted; convertible at $31.15 per share until two-thirds has been converted, and thereafter at $33.54 per share.

The investor must keep himself informed as to the expiration of the conversion privilege or other changes in it. This information is frequently given in corporate annual reports, and always is on file, for companies whose shares are traded on the New York Stock Exchange, in the corporate listing statements in the Stock Exchange library.

Dilution or change of the conversion privilege. Where one class of stock is convertible into another class, any change in the financial structure of the corporation may dilute, change, or destroy the conversion privilege, and the corporation as well as the holder of the convertible securities must watch the effect of a proposed change. The following changes, for example, may reduce the value of the conversion privilege: a split-up of the shares issuable upon conversion, or a change in such shares; a stock dividend; a sale of additional shares issuable upon conversion for less than a certain price; the issuance of subscription rights; the distribution of assets to the holders of senior securities; the issuance of other classes of stock having a preference upon redemption, liquidation, or dissolution; the issuance of another class of convertible securities offering the privilege of conversion into the same class of stock at a price lower than that offered to the first class of convertible stock. A consolidation, merger, sale of assets, or dissolution may wipe out entirely the conversion privilege.

Unless the corporation has obligated itself by contract to protect the holders of convertible securities against dilution of their conversion privilege, it is not required by law to do so, for, as Mr. Justice Holmes stated, the conversion privilege is simply an option to take stock as the stock may turn out to be when the time for choice arrives.[14] Usually, however, the document setting forth the terms of the conversion—that is, the certificate of incorporation in the case of convertible stock, and the deed of trust or trust indenture in the case of convertible bonds—contains provisions to protect the interest of holders of convertible stock against dilution, change, or destruction of the conversion privilege. The protection aims, through restrictions and adjustments of the conversion price, to give the holder of the convertible stock what he would have received had he converted

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[14] Parkinson v. West End Street Ry. Co., (1899) 173 Mass. 446, 53 N.E. 891.

his shares immediately before the change affecting the conversion privilege.

Thus, the protection afforded in case of a split-up or combination into a lesser number of shares of the stock issuable upon conversion, takes the form of a provision that the number of shares issuable upon conversion shall be replaced by the number of the subdivided or consolidated shares, as the case may be. Protection of the same order is provided in case the shares issuable upon conversion are changed into the same or a different number of shares of any other class or classes. The General Dynamics Corporation's 3½ per cent convertible debentures present an example of a conversion ratio altered by a stock split-up. Since the split of the company's common in 1956, the conversion price for each share of common is $49.46. Before the split-up, the conversion price was $74.20.

Convertible stock and the market. The convertible preferred stock of a corporation will rise with any increase in the price of the common stock into which the shares are convertible, provided the value of the common obtainable upon conversion is more than the investment value of the preferred. When the price of the preferred thus reflects its conversion value, a decline in the price of the common will result in a decline in the price of the preferred, but only to its investment value. Any further decline in the price of the common will not be directly reflected in the price of the preferred.

Ordinarily, the price of a convertible preferred stock on the market is kept in line with its conversion ratio because of the buying and selling that is constantly going on to take advantage of any differential between the price of the convertible preferred and the common into which it is convertible. How closely this arbitrage (the term applied to the process of buying and selling to take advantage of the differential) keeps the price in line is shown by the following example: On October 19, 1956, National Distillers and Chemical Co. preferred stock closed at 98, or equivalent to 37¾ per share of common stock, computed at the conversion ratio of 2.6 shares of common for one preferred. On the same day, National Distillers common closed at 28½. By June 25, 1957, National Distillers preferred was selling at 84, or equivalent to 31⅝ per share of common stock (at that time the conversion ratio was 2.65, the change having been caused by a stock dividend on common). On that day National Distillers common closed at 28, the differential having decreased about 6 points.

Preferred stock in series. The corporation laws of some of the states provide that preferred stock may be issued in series, with such preferences, restrictions, and limitations for each group as are fixed from time to time by resolution of the board of directors. Because the participation in the corporate income, preferences, and other privileges

are not set forth in the certificate of incorporation, this form of stock has sometimes been called "blank" stock. The directors give to a block of the preferred stock, at the time they undertake its sale, such attributes as will make it marketable.

Before series stock was authorized, a corporation could issue no other stock but that having the attributes prescribed by the charter; without an amendment of the charter no other stock could be issued, regardless of the financial position of the corporation and the suitability of the provisions of the issue to the demands of the times. It is not uncommon, as a result of the provision authorizing the issuance of preferred stock in series, to find one corporation issuing a series of stock called Series A, with cumulative dividends at one rate, and another called Series B, with cumulative dividends at another rate. National Lead Company, for example, has authorized 500,000 shares to be issued in series. Under this authority it has issued 7 per cent cumulative preferred, Series A, and 6 per cent cumulative preferred, Series B.

Summary of rights of preferred stock. Having described the various attributes that are commonly provided for in creating preferred stock, we may now inquire into the rights which a preferred stockholder has in the absence of a specific contract. Suppose, for example, that a certificate of incorporation provides that the stock of the company shall be divided into two classes, 7 per cent preferred, and common. What are the rights of the holders of the preferred stock? The general rule is that in the absence of a special contract the preferred has all the rights of the common. Hence the preferred would be voting, not preferred as to assets, not redeemable, and not convertible. Some courts say that it would be participating; others that it would not. The apparent exception to the rule is that in most states the preferred stock will be deemed to be cumulative and not non-cumulative.

Par value stock. Any class of stock may have a par value. Stock with par value means that each share has been given a par or face value, which is indicated in the certificate of incorporation (see page 12 for example) and on the face of the certificate of stock. The par value may be of any amount. Stocks with par value of $100, $50, $20, and $1 are common. Occasionally in the past, stock has been issued with a par value as high as $1,000, and today, as in the past, stock with par value of less than a dollar is sometimes created. The entire capital stock is equal to the par value of a share multiplied by the number of shares. Dividends are generally expressed as a percentage of the par value of a share. Thus, a 5 per cent preferred stock pays 5 per cent on its par value. On a $20 par share, the dividends would be $1 a year; on a $100 par share they would be $5 a year.

When par value stock is issued, the value of the consideration re-

ceived for it must be at least equal to the par value of the stock. Only then can the stock be issued as fully paid and non-assessable, indicating that holders of such stock have no liability to creditors.[15] In most states the stock may be paid for in cash, property, or services. When paid for in property or services, the fair value of such property or services must equal the total par value of the shares issued therefor.

To illustrate the stockholder's liability to pay for par value shares, suppose *A* subscribes to one share of $100 par value stock of Corporation *B* at $95 and pays the corporation $90. The corporation can collect $5 from *A* because he is liable to the company for the amount which he agrees to pay for the stock. A creditor, however, has the right to collect $10 from *A*, the difference between par and what *A* paid for the stock.

Shortcomings of par value stock. Par value stock has the following shortcomings:

1. It leads the uninformed owner of par value stock to think of the par value as the value of his shares. Actually, the par value is a fictitious value, or deceptive label, for the value of the stock varies with changes in the corporate earnings. The sophisticated investor is not misled. He has been educated to look to the earnings or earnings possibilities of the stock and to the net assets of the corporation in thinking of its value.

2. The requirement that the corporation must receive the full par value before the stock is "fully paid and non-assessable" sometimes makes it difficult to market the shares. For example, suppose a corporation has 100,000 shares of authorized capital stock with a par value of $10 per share. It has issued 50,000 of the shares and is in need of additional capital. It wants to sell the remaining 50,000 shares but because the market value of the outstanding shares has fallen below par it cannot do so. The corporation must rearrange its financial structure by amending its charter or it must raise the capital through borrowing.

3. When par value stock is to be issued to some of the organizers for property or services, and additional cash is to be raised by selling shares below par, a subterfuge must be used in order to limit the stockholders' liability on shares sold below par to the amount he agrees to pay for the stock. This subterfuge, or expedient, consists in issuing the shares in the first instance for the property valued at the par value of the total number of shares issued therefor. The vendor of the property then donates to the corporation part of the stock he receives and

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[15] If the directors may demand more than the par value of the stock, the stock is said to be "assessable." This form of stock has been abolished by law in many states.

since it has been paid in full with the property it may, as treasury stock, be sold at any price or given as a bonus. Bonus stock created in this manner has often been distributed with the sale of bonds or preferred stock.

Difficulties arising from "making" par value stock "fully paid." The expedient just described led to the practice known as "watering stock." Stock is said to be watered [16] if a fair appraisal of property received for stock shows the assets to be worth palpably less than the par value of the stock issued therefor. If stock-watering is proved, the holders are generally held liable as they would be if they had paid for the stock an amount of cash equal to the appraised value of the assets. In many court cases bonus stock with par value was found to have been issued for an inadequate consideration and the holders were held liable to creditors for their par value.

The fact that the person who has received the stock gives a part of it back gratuitously does not necessarily mean that his property was overvalued. That is a separate question of fact that must be determined from a fair appraisal of the property. For example, a mine owner has a report on his property showing it to contain $10,000,000 in ore which can be extracted at a cost, including marketing and administrative expenses, of $4,000,000. He turns the mine over to a corporation for $6,000,000 of its stock, fully paid, and gives back $2,500,000 of the stock to the corporation which the latter may now sell at any price. One can hardly call this an overvaluation of the property. The mine owner is willing to take only a part of the stock in order that he may get the money to turn his potential buying power into an active business that will yield him universally acceptable money. Treasury stock under the circumstances outlined above can be given away as a bonus without rendering the holders liable.

Stock without par value. The issuance of stock without par value was first permitted by the State of New York in 1912. Since then all but one [17] jurisdiction—Nebraska—have passed laws permitting the issuance of no-par stock. Broadly defined, no-par shares are stock with no face or designated value. The aggregate ownership is simply

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16 An interesting, and doubtless authentic, account of the origin of the term "watered stock" will be found in Chapter VI, Bouck White, *The Book of Daniel Drew* (New York: Doran, 1910). For other histories of stock-watering, see David L. Dodd, *Stock Watering* (New York: Columbia University Press, 1930); James C. Bonbright, *The Valuation of Property* (New York: McGraw-Hill Book Co., 1937).

17 Certain types of corporations may be prohibited by statute from issuing no-par stock—for instance, financial corporations such as banks, trust companies, insurance companies, and building and loan associations. The Public Utility Holding Company Act of 1935 provides that stock issued by holding companies for holding company purposes must be common stock with par value. Under certain circumstances, however, the Securities and Exchange Commission may permit the holding company to issue no-par stock.

divided into shares, and dividends are paid at the rate of so many cents or dollars and cents per share.

Although no-par stock has no face value, the price at which the shares are to be issued must nevertheless be fixed. When corporations are organized with no-par stock, the charter of the corporation generally gives the directors the power to determine the amount of consideration to be received for stock without par value. This consideration, as in the case of par value stock, may be in the form of cash, property, or services. The statutory provisions as to the quality of consideration for which the stock may be issued—the valuation of the property and services—apply alike to par value and no-par stock. The price at which the no-par stock will be sold upon original issuance must be set in the light of legitimate considerations such as appraised and sale value of assets, book values, market values of outstanding shares, present and probable earning power, market conditions, size of the issue, reputation of the corporation, and like influences.

When no-par statutes were first enacted, the primary objective was to permit the issuance of bonus stock as "fully paid and non-assessable." The intent of the statutes was to remove the deceptive par value label and to give notice to the holders of such stock that the value of the shares must be determined at any particular time from sources other than a statement of fictitious value on the face of the certificate. For many years there were definite advantages in using no-par stock rather than par value shares because it overcame the shortcomings of par value stock. However, changes in the no-par statutes, in the tax laws (see page 91), in the practices of stock issuance, and in accounting methods have made the differences between par value stock and no-par stock of little practical importance. In recent years it has been found that low par value shares serve the same purposes as no-par shares.

The no-par statutes. Although no-par statutes vary in the several states, they fall generally into the following types:

1. The statute requires that full consideration received for the no-par shares must be considered as capital. The full consideration must be paid before the shares can be treated as fully paid and non-assessable.

2. The statute indicates the minimum consideration for which no-par shares may be issued or requires the certificate of incorporation to indicate the minimum consideration. This minimum, applied to all of the outstanding no-par shares, is the statutory capital. The stock can be sold for a price equal to or in excess of this minimum. Any consideration received in excess of the minimum may be treated as "paid-in capital," "capital surplus," or "surplus." So far as creditors are concerned, the shares are treated as fully paid and non-assessable

when the minimum stated value has been paid. The only important difference between this type of no-par stock and par value stock is that the face of the certificate shows that it is without par value and does not indicate the stated value in the way that par value stock shows the par value: (See the illustration at page 97.)

3. The statute permits a portion of the purchase price to be allocated to "paid-in surplus." Usually, the board of directors is given power to determine by resolution the part of the consideration that is to represent capital. So far as creditors are concerned, the shares are fully paid and non-assessable when the portion designated as capital has been paid.

Many of the statutes require the corporation to have a certain minimum amount of capital before the corporation can do business (see, for example, Column 14 in Appendix A). This provision must always be met.

Stated value and stated capital. The term "stated value" is frequently encountered in the statutes dealing with the issuance of no-par stock. At one time, stated value referred only to the amount which the statute or the certificate of incorporation designated as the minimum sale price for each no-par share. Today, the term has a broader meaning. Under modern accounting conventions, the value shown in the balance sheet as the statutory capital allocable to no-par shares is called "stated" or "assigned" value.

"Stated capital" is a term used in some of the statutes instead of "capital stock." In such statutes it means "the par value of all outstanding shares having par value." Under these statutes any amount received in excess of the par value constitutes paid-in surplus.[18]

Shortcomings of par stock overcome by no-par stock. Let us see how the weaknesses of par value stock, mentioned at page 86, are overcome by no-par stock.

1. The fictitious values that might arise in the minds of unsophisticated investors from giving units of ownership a par value do not generally arise in the case of no-par stock. It may be argued, however, that the absence of a par value on the shares has not made the ordinary investor more diligent in studying the facts to arrive at the value of his shares. If he is inclined to make investigations of the earnings and values behind his stock, it is probably because the investing public is better educated today than when no-par shares were first introduced.

2. A corporation can sell authorized but unissued no-par stock from time to time at a price equal to its then fair value. Thus, the inflexibility of par value stock described as the second shortcoming at page 86 is overcome.

3. The third objection to par value stock, mentioned at page 86, is

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[18] Paid-in surplus created on the sale of stock is discussed further at page 390.

also met. No-par stock can be given such nominal values that no legal difficulties are encountered in issuing it as bonus stock, when that is desired. Thus, it is unnecessary for those who have sold property to the corporation for stock to donate part of their holdings to the corporation as treasury stock. Also, there is less incentive to overvalue property merely to balance the assets against stock issued for it. This does not mean, however, that property issued for no-par stock is never overvalued and that no-par stock is never watered. The use of no-par stock does not, in and of itself, protect subscribers to watered stock from liability for the difference between the value of the property and the value of the stock issued therefor. Nor does it protect directors against liability to creditors for overvaluation of property or services received in payment for the shares.[19]

Difficulties presented by no-par shares. No-par shares present certain difficulties, sometimes regarded as objections. They are as follows:

1. *Possible unfairness to existing stockholders.* If the directors should fix the price of an increased issue of no-par stock at a figure less than the actual value of existing shares, the interest of the old stockholders in the total net assets will be less than it was before the new stock was sold, since each share after the increase has the identical value of every other share of the same issue. Such unfairness would occur, however, only if the new stock were sold to others than the existing stockholders.[20] And then, existing stockholders would be protected against such impairment of their capital by their right to apply to a court of equity to prevent a dilution of their shares. Ordinarily, the directors cannot sell the same issue of no-par stock to different persons at different prices, but such sales have been sustained by the courts where it was shown that the transactions were fair and for the beneficial interest of the corporation.

2. *Possible unfairness to creditors and confusion of stockholders.* With no-par stock, the opportunity arises in some states to designate a large part of the consideration received for the stock as paid-in surplus. In many of these states it is possible for the corporation to return that capital to the stockholders as dividends from paid-in surplus. Should such action take place, it would be unfair to creditors who rely upon the amount of capital that the stockholders have invested in the business. Also, stockholders, who are accustomed to receiving dividends from corporate earnings, might be misled by a dividend distributed from paid-in surplus, unless they were informed of its source.

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19 Carlos L. Israels, "Problems of Par and No-Par Shares: A Reappraisal," 47 *Columbia Law Review* 1279 (1947).

20 The rights of existing stockholders to have new stock offered to them will be discussed in Chapter 13.

3. *Difficulty of analyzing the balance sheet.* Some of the no-par statutes permit practices that make it difficult for creditors, investors, and others to analyze the balance sheet. For example, under some of the statutes a corporation may let $1.00, or some other nominal amount, represent the capital attributable to shares without par value. Thus, the capital stock account of a Delaware corporation might appear as follows:

$8 Preferred Stock (18,625 no-par shares)	$652,225
Common Stock (12,907 no-par shares)	1

In New York, the corporation may give each no-par share a stated value of $1 or more, or it may consider the entire consideration received for the stock as capital. In a few states, the statutes merely require the corporation to indicate the number of no-par shares, and make no provision for designating any part of the amount received as capital. A corporation organized in a state having such a statute could show in its balance sheet merely the number of no-par shares without any dollar value for them.

Of course, it might be argued that if a balance sheet shows a nominal stated capital for no-par shares, or no dollar value whatever for such shares, creditors and investors are compelled to make more intensive investigations of the corporation's financial condition—a very desirable result, if they will do it.

Taxation of stock with par value and without par value. *Federal stamp taxes.* Until the Federal stamp law was amended in 1958, the Federal stock issuance and transfer taxes were important influences in determining whether stock should have par value or not, and what the par value should be.[21] But now the stamp tax is based on actual value whether the stock has a par value or not.

Organization taxes. However, a few states still impose organization and annual taxes on no-par stock at relatively high nominal value. For example, in New York, for purposes of measuring the organization tax, stock without par value is treated practically as though it had a par value of $100.[22] Suppose that a corporation is to be organized for $1,000,000 in New York, where the organization tax, based on authorized capital stock is 1/20 of 1 per cent of the par value ($.50 per $1,000 of authorized capitalization) and $.05 per share for no-par stock, The question arises as to whether the company shall incorporate with 200,000 shares of stock with par value of $5 each or shall provide for 200,000 shares of stock without par value, but to be sold at $5 per share. The New York organization tax for the

21 The tax on par value was based on the face value, but the tax on no-par stock was based on the number of shares.

22 In other states, the arbitrary value fixed for no-par stock is less.

company with stock having par value would be $500; for the company having stock without par value, $10,000. In other words, to use stock without par value would involve an additional cost of $9,500.

State annual privilege taxes. A number of states set an arbitrary value ranging from $10 to $100 on no-par shares in computing the annual privilege taxes where the tax is measured by authorized or issued capital stock, or both.

Other classes of stock. Certain terms that are used to describe shares of stock may be briefly referred to here.

Prior preference. Sometimes, after preferred stock has been issued, another stock, which in effect is a first preferred but which is called prior preferred, may be issued with the consent of all the stockholders. A classification of preferred stock in order of priority also gives rise to the titles of "first preferred" and "second preferred." Wheeling & Lake Erie Railway Co. calls its preferred stock "4 per cent cumulative prior lien stock" although there are no other preferred shares outstanding. The title of a stock does not necessarily show its rank, the choice of name frequently having been determined by popular designations at the time the issue was created.

Deferred stock is stock on which dividends are to be deferred until payment has been made on another class. It is usually created in connection with some form of readjustment of the capitalization.

Guaranteed stock is a term sometimes used as a synonym for preferred stock, but when so employed is a misnomer, for a company cannot "guarantee" dividends on its own stock. The title is correctly used when applied to a stock, the dividends on which are guaranteed by another corporation. For example, a parent company may guarantee dividends on the stock of a subsidiary, and in that event the guarantee amounts to a debt owed by the parent company to the stockholders of the subsidiary, conditioned on the failure of the subsidiary to pay its own dividends.[23] Examples of guaranteed stock in American finance are numerous. The Pittsburgh, Cincinnati, Chicago & St. Louis Railroad Co., for example, guarantees dividends on the original guaranteed stock of the Little Miami Railroad as well as on that company's special guaranteed betterment stock.

Special stock is very much like debentures, issued under the terms of a special statute of Massachusetts. Dividends on this stock are a debt of the company, and all the general stockholders are liable personally for all debts and contracts of the company until the special stock is fully redeemed. It is not used now, so far as we can ascertain.

Debenture stock is an English term. It really does not indicate a share of stock at all, but means a bond; if the term is used in this

[23] See Windmuller v. Standard, etc., Co., (1906) 105 N. Y. App. Div. 246, affirmed without opinion in 186 N. Y. 572.

country it generally indicates what is usually termed debenture bonds. It is most frequently used in connection with government finance.

Protected preferred stock. Protected preferred stock, which was first issued, so far as we know, in the promotion of the May Department Stores Company in 1910,[24] provides that profits must be conserved by being placed in a "special surplus account" to pay shortages in preferred stock dividends in the lean years when current profits are insufficient.[25] Thus, whereas the cumulative feature looks backward to clear up dividends in arrears, the protective feature looks forward to avoid non-payment of dividends.

Founders' or management shares are more frequently used in foreign than in American corporations. Generally they answer to the definition already given of deferred stock, though the term is sometimes applied to shares of stock the holders of which have contracts essentially different from those of the holders of deferred stock. Founders' shares are usually issued in smaller amounts than other classes of stock, and generally carry dividend provisions that encourage the directors or founders, who are the holders of such shares, to increase the earnings of the corporation. Thus, at one time the holders of founders' stock of New York Shipbuilding Corporation were entitled to 35 per cent of the net earnings as a class, and were the only class with voting power. Frequently, provision is made that other classes of stock shall share the voting power if dividends on such other stock are not paid. The term *bankers' shares*[26] is also applied to a class of stock that has sole voting power and is held by a small group, generally the organizers of the corporation and the bankers who financed the issues. It would thus be the same kind of stock as the "management shares" described above. The trend in recent years, however, has been away from shares that concentrate control in the hands of a small group of managers or bankers.

Promoters' stock. This term is applied to stock given to promoters in part or full payment for services rendered. Promoters' stock is similar to management and bankers' shares described above. The pro-

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24 The protected preferred stock of the May Department Stores Company was retired in 1927.

25 Probably the idea of protected preferred is derived from the French corporation law which has been copied by most of the countries on the continent. Article 36 of the Law of 1867 provides that the company must put aside five per cent of its net profits annually as a reserve fund until the fund is equal to ten per cent of the capital.

26 In 1919 the Cities Service Company deposited 30,000 shares of common stock under an agreement with a trust company, and the latter issued against these 300,000 "bankers' shares." These so-called bankers' shares were merely non-voting certificates of beneficial interest in the stock of the company and were exchangeable, ten bankers' shares for one common share. The device permitted the company to sell its stock in small units without reducing the par value. The agreement was terminated in 1938, and bankers' shares were exchanged for common stock.

certain period and thereafter detachable. If the warrant is non-detachable, there can be no market in warrants alone, and the warrant may be exercised only by presentation thereof attached to the stock certificate or other security. Provision is usually made to permit the holder of a non-detachable warrant to exercise a portion of the warrant.

Limitation of stock purchase privilege. Stock purchase warrants may be perpetual, but only a very few perpetual warrants are outstanding. Warrants usually are limited in time, as in the case of conversion rights, or they are scaled to permit the exercise of the warrant at a certain price during one period and at increasingly higher prices during later periods. For example, the Silex Company had outstanding on December 31, 1955, warrants to purchase 48,867 common shares at $4 per share to June 1, 1956; at $4.20 per share from June 2, 1956, to June 1, 1959; at $4.40 per share from June 2, 1959, to June 1, 1962; and at $4.60 per share from June 2, 1962, to June 1, 1966; issued to the purchasers of the 5½ per cent debentures (due 1966) which were sold in 1953.

The effect of making the purchase price higher as time goes on is to hasten the exercise of the privilege. Limiting the period during which the warrants are valid is intended to prevent dilution of the securities after they have become seasoned.

Purchase and sale of warrants. Detachable warrants, or separate stock purchase warrants, may be bought and sold in the market. So long as the market price of the stock purchasable with the warrant is higher than the warrant price, the warrant has a definite exercise value. The warrant may be worth more than the actual difference between the market price of the stock and the exercise price, for it may have a value added to it by the prospect of its becoming more valuable. Warrants may also have a value at a time when there is no difference between the market price of the stock purchasable with the warrant and the warrant price, or when the market price of the stock purchasable is less than the warrant price—showing that the warrant has a speculative value.

Trading in warrants was popular during the stock market boom of the late twenties, because it permitted holders to make a profit through rises in the value of stock, without tying up more capital than was represented by the cost of the warrant. Later, the popularity of warrants declined, but there has been some resurgence of interest in them in the 1950's, particularly in the security markets if not in the new issues.

The stock purchase warrant may be used by one engaged in a short sale of stock to protect himself against heavy losses. If the stock sold

short fails to move down as expected, but rises instead, the holder of the warrant can always obtain the stock by exercising the warrant and paying the subscription price.[27]

Dilution, change, or destruction of stock purchase warrants. The same changes in financial structure that dilute, change, or destroy the conversion privilege will affect similarly the rights and interests of the holders of stock purchase warrants. To protect the holder of the warrant against an impairment of his interest, the instruments creating the stock purchase warrant usually make provision similar to that described with respect to convertible stock on page 83.

For example, a stock split-up of the shares purchasable with the warrants, or an additional issue of shares purchasable with the warrants, or a sale of such shares at a price lower than the subscription price to the warrant holder, will reduce the value of the stock purchase warrant. The usual protection against such changes is an adjustment of the price to be paid for the stock as well as of the number of shares purchasable.

Disadvantages of stock purchase warrants. Since the exercise of the stock purchase warrant is at the option of the holder of the stock, the corporation may be furnished with cash at any time whether it is in need of cash or not. Usually the warrant is exercised when the company is most prosperous, and therefore when it is least in need of additional capital.

The use of the stock purchase warrant ties up a certain amount of unissued common stock for an indefinite period and prevents the issuance of that amount of stock at one time for a lump amount of new capital when needed. On the other hand, corporations that are growing and that are regularly in need of capital may find the stock purchase warrant an excellent device for obtaining capital to meet a growing capital requirement.

If the corporation is successful, the price fixed in the stock purchase warrant may become much lower than the ascending value of the stock purchasable with the warrant. This leads to the disadvantage that those holding the shares purchasable with the stock warrants will find the book value of their shares, as well as their participation in the earnings, constantly subject to dilution.

Where the stock purchasable with the warrants has voting power, exercise of the privilege may affect the voting control of the company.

Certificates of stock. Restating what was said under the definition of stock, certificates of stock are evidence of ownership of shares. A certificate of stock is illustrated at page 97. Although stock cer-

[27] See page 275 for an explanation of short sales of stock. See *Stock Exchange Practices*, Report No. 1455, 73d Congress, 2d Session, p. 51, for examples of profits made by short selling against options.

No. 523

COMMON STOCK

Certificate

No. ________

For ________ Shares

Issued to

____

____

Dated ________ 19__

From whom transferred

____

Dated ________ 19__

No. Original Shares	No. Original Certificate	No. of Shares Transferred

Received Certificate No. ____

for ________ Shares

this ____ day of ____ 19__

____

____

COMMON STOCK

No. **Shares**

INCORPORATED UNDER THE LAWS OF THE STATE OF DELAWARE

Livingston Manor, Inc.

TOTAL AUTHORIZED ISSUE 1100 SHARES

Preferred Stock 1,000 Shares
PAR VALUE $100 EACH

Common Stock 100 Shares
WITHOUT NOMINAL OR PAR VALUE

THIS CERTIFIES THAT ________________

is the owner of ________________ *Shares of the COMMON Stock of*

LIVINGSTON MANOR, INC *full paid and non-assessable*

transferable on the books of the corporation by the registered owner in person or by duly authorized attorney, upon surrender of this certificate properly endorsed.

The designations, preferences, privileges and voting powers or restrictions or qualifications, upon which the Preferred and Common Stock of the Corporation are issued, are set forth upon the reverse of this certificate, reference to which is hereby made and to all of the provisions of which the registered owner hereof and his assigns, by the acceptance of this certificate, agree.

IN WITNESS WHEREOF the said corporation has caused this Certificate to be signed by its duly authorized officers and to be sealed with the seal of this corporation

this ________ *day of* ________ 19____

Secretary Treasurer

President - Vice President

Stock Certificate and Stub.

tificates are not ordinarily issued by a corporation before the stock has been fully paid, there are instances, especially in small corporations, when the company issues the certificate before full payment has been received and marks it "part paid." [28]

Stock certificates have been made negotiable by the Uniform Stock Transfer Law, which has been adopted by all of the states. If the owner endorses the certificate in blank, and it is lost or stolen and gets into the hands of an innocent purchaser, the latter gets good title as against the original owner. When certificates are lost, it is usual to notify the transfer agent immediately. If the certificate is not recovered, the owner puts up a bond to protect the company against the claims of a subsequent innocent purchaser, complies with certain requirements of the corporation, and the company thereupon issues a new certificate.

Methods of issuing and recording shares. If Faith Jones pays in full for 100 shares of stock of Livingston Manor, Inc., she will receive one certificate certifying that she owns 100 shares. In small corporations the transfer agent is usually the secretary and he records the issuance and transfer of stock on the stub in the stock book (see illustration). In large corporations it is usual to engage a trust company as transfer agent and it countersigns the certificates, and enters the issuance and transfer of stock in a stock ledger. A further check is provided in large corporations through registration by a registrar.

If Faith Jones wishes to sell 40 shares to John Smith, she will fill out an assignment, the form for which is reproduced below, and will send the certificate to the transfer agent. The transfer agent gives the agent of Faith Jones a deposit slip for 100 shares and tells him that the certificates for 40 and 60 shares will be ready for delivery in a few days. The transfer agent will then take two certificates already signed by the officers of the corporation and will make them up, one for 40 shares for John Smith and the other for 60 shares for Faith Jones. He will cancel the old certificate for 100 shares, countersign the new certificates for 40 and 60 shares, and send all three over to the registrar, usually another trust company.[29] The registrar compares the new certificates with the old to see that the new certificates aggregate the same number of shares as the old certificate. He countersigns the new

[28] It would seem that where a corporation is not prevented from doing so by statute, it may issue certificates before stock is fully paid and pay dividends on its par value even though other shares are paid in full. See A. Machen, *Modern Law of Corporations*, page 433. As to states not permitting issue of certificates, see W. M. Fletcher, *Cyclopedia of the Law of Private Corporations* (Chicago: Callaghan & Company, Inc.), Vol. 11, §5161. Usually a corporation will agree to pay "interest" on installments at the current dividend rate. Sometimes interest is paid at a rate lower than the dividend rate.

[29] Stock listed on the New York Stock Exchange must be registered with an independent company.

certificate, cancels the old one, and returns all three to the transfer agent. The new certificates are then ready for delivery upon presentation of the deposit slip. A receipt is usually required upon delivery. The old cancelled certificate is filed away in the transfer agent's office. Eventually it may be cremated by the transfer agent along with other cancelled certificates, upon proper authority.

THE DESIGNATIONS, PREFERENCES, PRIVILEGES AND VOTING POWERS OR RESTRICTIONS OR QUALIFICATIONS OF THE SHARES OF EACH CLASS ARE AS FOLLOWS:—

The authorized shares of stock without par value may be issued by this corporation from time to time for such consideration as may be fixed from time to time by the Board of Directors and any and all shares without par value so issued the consideration for which so fixed has been paid or delivered, shall be fully paid stock and shall not be liable to any further call or assessment thereon and the holders of such shares shall not be liable for any further payments in respect of such shares

The holders of the shares of Preferred Stock shall be entitled to receive and the corporation shall be bound to pay thereon preferential dividends as and when declared by the Board of Directors out of the annual net profits of the corporation or out of its net assets in excess of its capital as determined pursuant and subject to the provisions of the General Corporation Law of the State of Delaware at the rate of Five (5%) per centum cumulative from the date of issuance and payable semi-annually on the first day of January and July before any dividends shall be declared or paid upon or set apart for the holders of the shares of Common Stock

After full dividends at the rate of Five (5%) per centum for the then current year and all previous years shall have been declared and paid upon or set apart for the holders of the shares of Preferred Stock additional dividends may be declared or paid or set apart during such year Such additional dividends if declared shall be set apart for or paid exclusively to the holders of the shares of Common stock share and share alike subject however to the provisions hereinafter contained to the effect that no dividends shall be paid on the Common Stock until all of the outstanding Preferred Stock has been either redeemed or funds have been set apart for such redemption

The corporation through its Board of Directors and conformable with the General Corporation Law of the State of Delaware may from time to time redeem the whole or any part of the Preferred stock at the price of One Hundred Dollars ($100) per share plus any arrearages of dividends thereon that may be due and payable to the date of such redemption The notice of such redemption shall be mailed not less than thirty (30) days prior to the date upon which the stock is to be redeemed to each holder of stock so to be redeemed at his address as it appears on the books of the corporation In the event that less than all of the outstanding Preferred Stock of the corporation is to be redeemed the amount to be redeemed and the method of effecting such redemption whether by lot or pro-rata or otherwise may be determined by the Board of Directors On and after the date fixed for such redemption the holders of shares so called for redemption shall cease to be entitled to any further dividends on such preferred stock and the respective holders thereof shall have no right or interest thereon or therein by reason of the ownership of such shares, except to receive the said redemption price plus arrearages of dividends as a debt without interest upon presentation and surrender of their certificates therefor

In the event of any liquidation dissolution or winding up of the corporation, whether voluntary or involuntary the holders of the shares of Preferred Stock shall be entitled to receive out of the assets of the corporation (whether from capital or surplus or both) the par amount of their Preferred shares plus any arrearages of dividends that may be due and unpaid thereon to that time before any distribution shall be made to the holders of the shares of Common Stock and thereafter the holders of the shares of Common Stock shall be entitled to the exclusion of the holders of the shares of Preferred stock to share ratably in all assets of the corporation remaining after such payment to the holders of the shares of Preferred stock If upon such liquidation dissolution or winding up of the corporation the assets of the corporation shall be insufficient to permit the payment in full to the holders of the shares of Preferred stock of the amount distributable as aforesaid then the entire assets of the corporation shall be distributed among the holders of the shares of Preferred stock The foregoing provision of this paragraph shall not however be deemed to require the distribution of assets among the holders of the shares of Preferred stock and the holders of the shares of Common stock in the event of a consolidation merger lease or sale which does not in fact result in the liquidation or winding up of the enterprise

No dividends shall be paid on the Common Stock until all of the outstanding Preferred stock has been either redeemed or funds have been set apart for such redemption and any holder of common stock shall have the right to demand the prompt redemption of all outstanding Preferred stock if there are sufficient funds available for such purpose, and in that case and upon such demand the preferential dividend of Five (5%) percent on such Preferred Stock shall thereafter cease to be payable thereon and the directors may declare and pay such dividend or dividends upon the Common Stock as will then be advisable from the surplus funds of the Corporation.

The corporation shall not issue any Preferred stock except for actual cash paid to the corporation in the amount of the par value of the Preferred stock so issued

Subject to the General Corporation Law of the State of Delaware the voting power shall vest exclusively in the holders of the shares of Common Stock.

For Value Received, _____ hereby sell, assign and transfer unto ______________________________

______________________________ Shares of the Capital Stock represented by the within Certificate, and do hereby irrevocably constitute and appoint

______________________________ Attorney to transfer the said Stock on the books of the within named Company with full power of substitution in the premises

Dated _______________ 19___

In presence of

____________________ ____________________

NOTICE: THE SIGNATURE OF THIS ASSIGNMENT MUST CORRESPOND WITH THE NAME AS WRITTEN UPON THE FACE OF THE CERTIFICATE, IN EVERY PARTICULAR, WITHOUT ALTERATION OR ENLARGEMENT OR ANY CHANGE WHATEVER.

Back of Stock Certificate Showing Description of Each Class of Stock and Form of Assignment.

In the case of an original issue of stock, the registrar makes sure that the certificates issued by the transfer agent do not call for more shares than equal, with the stock already issued, the authorized capital

stock of the company. The registrar, from the stock register, can always tell how many shares are issued and how many shares may be issued.[30]

Under the common law, directors may not place any restrictions on the free transfer of the shares of stockholders. Statutes, however, usually give the directors power to make reasonable regulations to protect the corporation and bona fide stockholders against loss.

Summary of fundamental rights and liabilities of stockholders. Now that we have described the characteristics of the corporation (Chapter 1), how corporations are managed and controlled (Chapter 4), and the nature of corporate stock, most of the fundamental rights of stockholders have been explained. Of the following enumeration of these rights only those listed below as numbers 8, 9, and 10 call for further explanation. These will be treated at an appropriate time later.

Each stockholder has the fundamental right:

1. To a certificate showing his ownership of shares.
2. To transfer ownership of his shares.
3. To vote for directors.
4. To vote on other questions affecting the corporation's property as a whole.
5. To restrain *ultra vires* acts of the corporation.
6. To protect the corporation against wrongful acts of the directors.
7. To inspect the books of the corporation.
8. To receive dividends when they are declared.
9. To subscribe in proportion to his holdings for any new issue of stock.
10. To share in the proceeds of dissolution.

A stockholder is liable to pay the corporation the full amount that he has agreed to pay for the stock. This liability is contractual and may be enforced as such by the company whether or not there are unpaid creditors. When stock is part paid, the unpaid balance is usually subject to "call," that is, the directors may call for payment of part or all of the unpaid portion, provided, of course, all stockholders are treated alike. Subscription agreements to stock usually provide that where such calls are not met, the stock may be forfeited and sold for the benefit of the defaulting stockholder. Thus, if *A* owned 100 shares, 50 per cent paid up (for which he had agreed to pay $100 per share), and a call was made for $10 a share, *A* would either have to pay the $1,000 or the corporation would sell his stock at the best price it could get. If *B* bought the shares for $80 each, $50 would be used

[30] For detailed description of procedure for original issuance and transfer of stock, see Doris and Friedman, *Corporate Secretary's Encyclopedia* (Englewood Cliffs, N. J.: Prentice-Hall, Inc., 1958).

to make the stock fully paid and the remainder, less expenses of the sale, that is, $3,000, would be returned to *A*. The exact rules on forfeiture must be consulted in the statutes of the several states.

A stockholder's liability to the corporation must be distinguished from his statutory liability to creditors of an insolvent corporation. The statutes generally povide that if a person holds stock that is not fully paid, he will be liable to pay creditors the amount necessary to make his stock fully paid, or as much thereof as is necessary to pay the debts. In the case of par value stock, the maximum liability is the difference between the par value of the stock and the amount that has been paid thereon. In the case of no-par stock, it is the difference between the price fixed by the directors as a consideration for the no-par stock at the time of issuance (or its stated value, in some instances) and the amount that was paid thereon. The statutory liability for labor debts, and other exceptions, was explained at page 9.

Problem

1. The Carlson Manufacturing Company, Inc., balance sheet is as follows:
(in millions)

Cash	$ 1,422	Accounts payable	$ 1,365
Accounts receivable	860	Notes payable	500
Inventory	1,450	Bank loan (5-year)	1,500
Land	1,000	Bonds, first mortgage	2,700
Building (net)	3,500	Preferred stock	1,000
Equipment	2,971	Common stock $10 par	3,500
Treasury stock	500	(10,000,000 shares auth.)	
Goodwill	1,000	Earned surplus	1,138
		Capital surplus	1,000
Total	$12,703	Total	$12,703

(a) What is the capital of this corporation?
(b) What is the capitalization?
(c) What percentage of the capital is composed of debt, of preferred stock, of common stock, of surplus?

2. The Hall Corporation has 4 per cent preferred stock, $100 par value, convertible into 4 shares of common, $25 par. It is callable at 105 at any dividend date upon 30 days' prior notice.
(a) If the common is quoted at 40, what will be the price of the preferred?
(b) If the common is quoted at 20, what will be the price of the preferred?
(c) The dividend on the common is raised to $3 per share and the stock is quoted at 30. You paid par for the stock. Would you convert? Explain.
(d) The common is selling at 30 and the preferred at 120 and is about to be called. Would you convert? Give your reason.

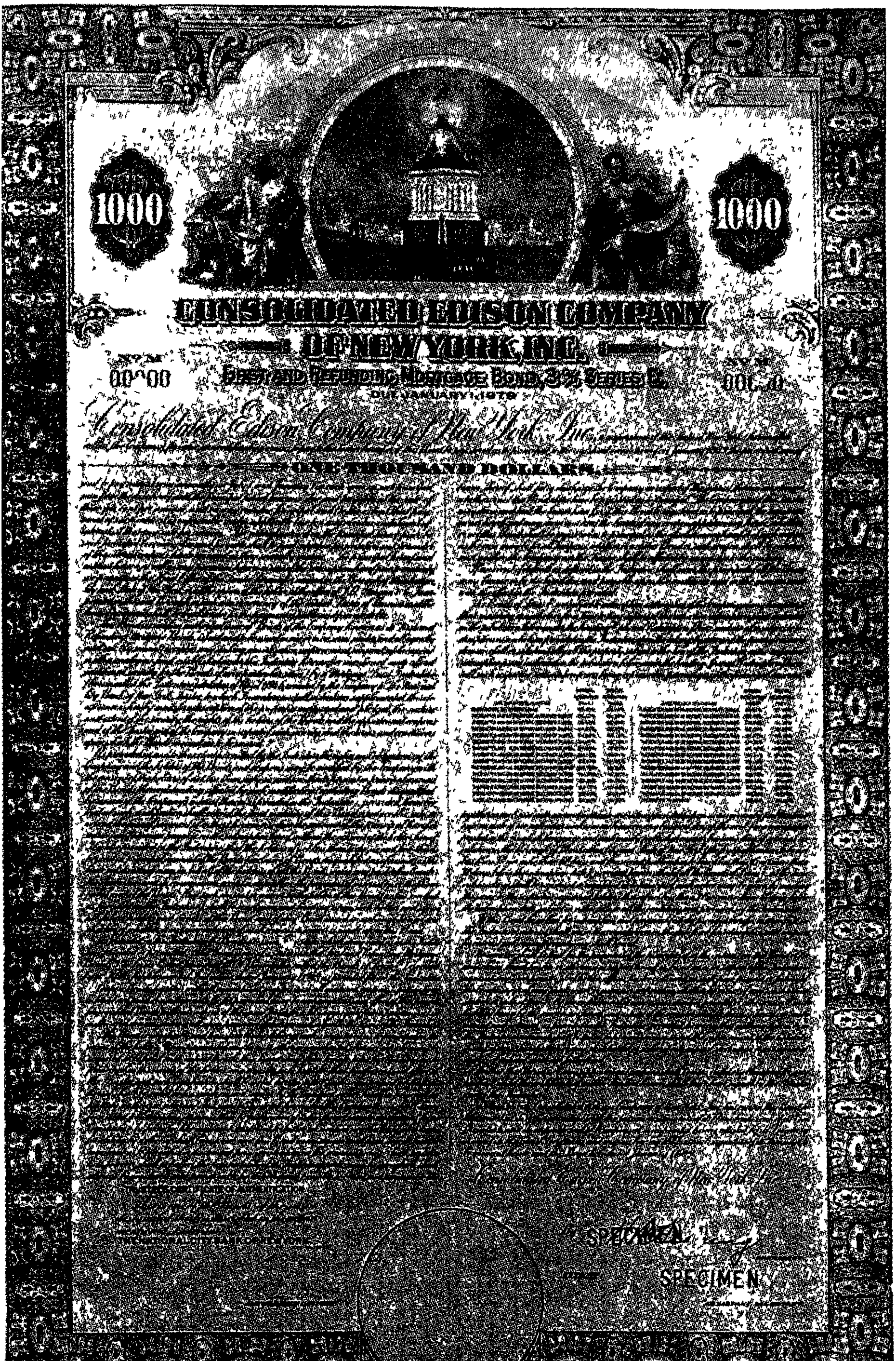
CHAPTER 6

General Characteristics of Corporate Bonds

Distinction between equity capital and borrowed capital. A corporation may raise money in two ways: (1) by taking the persons who furnish it into the enterprise as owners, and (2) by making them creditors. Those who become owners are known as the stockholders, and the capital they furnish is known as equity capital. In the preceding chapter we discussed the types of stock that may be issued by the corporation. The money that creditors furnish is known as borrowed capital. Without the permanent investment of equity capital by the stockholders it would not be possible for a corporation to borrow.

Long-term debt. When money is borrowed for the purchase of merchandise that is to be resold, the term for which the loan is made is likely to be determined by the time it takes to resell the goods. Short-term borrowing to carry such goods will be discussed in the chapters on working capital. When, however, money is borrowed for the purchase of land, or for the construction of a building, or for acquiring any other capital goods, the term of the loan is likely to be long enough to give the borrower time to repay the loan out of the earnings of the capital assets. If the loan is very large and is made by many persons, the debt it creates is divided into similar parts, each evidenced by a separate negotiable bond. The debt is said to be "funded" when it is evidenced by securities that do not mature for a considerable period of time.

In order to understand the basic principles of borrowing, it is necessary to understand the nature of the instruments by which long-term borrowing is accomplished. This chapter, therefore, will serve as an introduction to the more fundamental aspects of long-term borrowing that will be discussed in the following chapters. Some of the prin-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CONSOLIDATED EDISON COMPANY
OF NEW YORK, INC.
ONE THOUSAND DOLLARS
SPECIMEN
SPECIMEN

ciples of borrowing will become clear as the methods of financing with bonds are explained. They will be crystallized for the reader when capitalization is discussed immediately following the chapters on borrowing.

Bond defined. A corporate bond is a written promise, under seal, to pay a specified sum of money at a fixed time in the future, usually more than ten years after the promise is made, with interest at a fixed rate, payable at specified interest dates. The amount of the bond is ordinarily $1,000, although $500 bonds, $100 bonds, and even $50 bonds are becoming common. The face of a bond is reproduced on page 103.

Usually a corporate bond is one of a number of similar bonds, all of which are covered by a so-called deed of trust that sets forth the obligations of the corporation and the rights of the bondholders. The deed of trust is made out to a trustee who represents all of the bondholders, whoever and wherever they may be at any time.

Distinction between stock and bonds. A bond is evidence of a debt; stock is evidence of ownership. With this basic distinction in mind let us compare the two classes of securities in three respects: (1) rights of the holders to income; (2) rights to a voice in the management; (3) rights to a return of the investment.

Rights to income. A bond pays interest; stock pays dividends. A corporation definitely promises to pay the interest on the bonds at the rate specified in it at the dates mentioned in the bond. The interest on the bond is a fixed charge,[1] so far as the corporation is concerned. It must be met before the directors can think of paying dividends even to the preferred stockholders. The failure to pay interest coupons as they mature usually constitutes a default that accelerates the maturity of the principal of the bonds and precipitates receivership and reorganization. Usually a grace period is given in the indenture before this takes place. On the other hand, when a dividend is "passed," that is, not paid, because the company has no surplus from which to pay it, no such severe consequences ensue.

Rights to a voice in the management. Bondholders ordinarily do not have voting rights and therefore have no voice in the management of the corporation. Stockholders, we have seen, have a voice in the management through their voting rights.

Rights to a return of principal. The amount of the bond indicated on its face is the principal of the bond, also known as "par." The principal is payable at the maturity of the bond. If the corporation defaults in the repayment of the principal, the trustee must exercise the rights and powers vested in it under the deed of trust to protect the interests

[1] Dividends on preferred stock are often referred to as "contingent charges" and dividends on common stock as "optional charges."

of the bondholders. Sometimes a corporation arranges to refund the debt at or before maturity. Refunding means that the bonds are exchanged for other securities. The obligation of the corporation to repay the principal constitutes a basic distinction between bonds and stock. The bond obligation is a liability to creditors; stock is a part of the net worth and represents ownership, not a debt. Even the redemption clause in a preferred stock does not make the stock a liability.

The deed of trust. The agreement between the corporation and the trustee has already been referred to as the deed of trust. It may also be called a "trust agreement" or "trust indenture." Its function is to set forth all the terms and conditions of the bond issue and the rights, powers and duties of the parties to the bond issue. These parties are the corporation that borrows the money, the trustee through whom the corporation deals with the bondholders, and the bondholders themselves. The bond and the deed of trust constitute the bondholders' contract with the corporation. The deed of trust is usually a lengthy printed legal document that the bondholders ordinarily do not see. They may, however, obtain a copy on request of the corporation or the trustee. The bondholder can learn all of the essential terms of his contract with the corporation by reading what is printed on the face of the bond. Rarely, however, do bondholders bother to do so.

The contents of the deed of trust vary somewhat with the type of bond that is to be issued. Usually, however, a deed of trust is arranged as follows: It opens with the date of the instrument and the names of the parties. This is followed by a series of recitals that cover the authorization of the issue and the exacting wording of the bond, the interest coupons, the trustee's certificate, and the registration and endorsement that appear on the reverse side of the bond. Then come the articles of the trust instrument, which describe the properties pledged as security, state the agreements, restrictions, and the remedies of the trustee and the bondholders in the event of default, and describe the redemption and conversion rights and procedures, if any. The instrument closes with an attestation, which includes the signatures of the parties.

The trustee. Bondholders are usually numerous and scattered. Obviously, as individuals they would find it extremely difficult, if not impossible, to determine whether the corporation was complying with the terms of the trust deed. They would, of course, know if interest on the bonds were not paid. As individuals they would find it extremely costly and troublesome to take the steps necessary to protect their rights. Also, the corporation does not want to deal with each of its bondholders separately, for each, separately, might place a different interpretation on the agreements contained in the deed of trust and

chaos would be the result of the negotiations. For these reasons, unless a bond issue is extremely small, it is customary to appoint as trustee some trust company that is experienced in the handling of bond issues and that has adequate facilities to carry out the steps necessary in the issuance of the bonds and subsequent to issuance. One or more individual trustees may also be appointed and provision made in the trust deed for appointment of a successor or successors in the event of removal, resignation, or death. The chief function of the individual trustee is to take property in foreign states upon default, and thus spare the corporate trustee the necessity of qualifying to do business in the foreign state.

As previously indicated, the trustee's duties both before and after default under the trust indenture are fully set forth in the deed of trust.

Duties of trustee. The primary duty of the trustee is to protect the interests of the bondholders. The corporation is accountable to the trustee for neglect in its management of the property covered by the trust deed. If the trustee fails to see that the corporation protects such property, the bondholders may have the trustee removed and a new trustee appointed. The trustee is not a guarantor of the bonds. He is, however, liable to the bondholders for the breach of his trust. Thus, a trustee who certifies bonds upon delivery of securities that do not satisfy the requirements of the trust deed may be held guilty of negligence. A trustee who fails promptly to notify bondholders of the corporation's default may be held liable in damages to the bondholders.

Some of the principal duties of the trustee are explained below; special duties in connection with equipment trust obligations will be treated in the following chapter.[2]

Authentication of bonds. In large bond issues plates are engraved with great care for the printing of the bonds. When the bonds have been printed, and proper steps have been taken to see that no spurious blanks are circulated, the bonds are placed in the custody of the trustee. Before the bonds are issued, the trustee must authenticate them. Authentication consists simply in signing a certificate usually found on the outside panel of the bond.

The authentication shows that no more bonds have been issued than are authorized in the indenture. It does not represent the bond to be a valid obligation of the company. It does not state that the company has gone through the proper formalities prescribed by law for the issuance of bonds. It merely states that it is issued under the trust agreement. But the certificate does protect an innocent purchaser of the bonds, even if they are wrongfully sold or pledged by an officer of the company for his own benefit.

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[2] See pages 128 et seq.

Checking performance of covenants. The company promises to do many things besides paying the interest on the bonds and redeeming them at maturity, though, to be sure, these are the two chief obligations of the borrower. It is the duty of the corporate trustee to see that the corporation performs its obligations. To enable it to do so, the trust deed usually gives the trustee the right to inspect the books and records of the company, and to request the corporation to furnish it with such information and statements as it needs for the purpose. The trustee also receives copies of annual reports and of other information that must be filed with the Securities and Exchange Commission.

Enforcing the terms of the indenture. In case of default in the payment of interest and principal, the trustee is permitted to take possession, obtain the appointment of a receiver, accelerate the maturity of the total debt, and bring suit to recover judgment in its name against the corporation for the total amount of principal and interest due and unpaid.[3] The trustee is usually required by the indenture to exercise the care of a prudent man similarly situated in carrying out its duties, rights, and obligations under the indenture. The indenture may provide that not less than a majority of the bondholders may direct the time, method, and place of conducting any proceeding for any remedy available to the trustee.

The Trust Indenture Act of 1939. When investigations were made by the Securities and Exchange Commission in the middle thirties[4] of the work of trustees under trust indentures when defaults occurred, it was found that bondholders did not receive the protection, so far as enforcement of their rights was concerned, that they might have expected from the trustees. As a result, the Trust Indenture Act of 1939 was enacted. The statute regulates trust indentures covering bonds, debentures, notes, and similar securities that are publicly offered by the means and instrumentalities of transportation or communication in interstate commerce.[5] The purposes of the Act are: (1) to provide full and fair disclosure of the essential provisions of the indenture at

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[3] Indentures frequently provide that the holders of a stated percentage of the bonds outstanding may consent, on behalf of all the security holders, to the waiver of any past default (except in the payment of principal and interest) and its consequences. They may thus control the trustee's proceedings. It may also provide that holders of not less than, say, 75 per cent of the securities outstanding may consent on behalf of all the security holders to the postponement of any interest payment for a period not exceeding three years from its due date.

[4] "Trustees under Indentures," Securities and Exchange Commission, *Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees,* Part VI (Washington, D. C.: Government Printing Office, 1936).

[5] Securities exempted from the provisions of the Securities Act of 1933 (see page 223), with a few exceptions, are exempt from the Trust Indenture Act. Certain small issues are also exempt. For detailed list of exemptions, see Prentice-Hall Securities Regulation Service.

original issue and throughout the life of the securities issued under the indenture; (2) to provide machinery for such continuing disclosure and to enable security holders to unite for the protection of their own interests; (3) to assure security holders that they will have the services of a disinterested trustee, who will conform to the high standards of conduct observed by the more conscientious trust institutions; and (4) to provide minimum standards of qualifications of corporate trustees and of terms of indentures. The standards prescribed affect those provisions of the indenture that relate to the protection and enforcement of the rights of the investors.

These purposes are accomplished by requiring that indentures subject to the Act shall be "qualified" as conforming to specific statutory requirements expressed in the Act. Indentures covering securities required to be registered under the Securities Act of 1933 [6] do not require formal qualification; the registration requirements are sufficient to assure a trust indenture that conforms with the Trust Indenture Act. To qualify a trust indenture covering securities not required to be registered under the Securities Act, the issuer must file an application with the Securities and Exchange Commission. The processing of this application is a check-up on the provisions of the trust indenture to see that they conform to the law.

The Securities and Exchange Commission is entrusted with the duty of seeing that the terms of each indenture conform to the Act. It has no power with respect to enforcement of the provisions of the indenture. Civil and criminal liabilities imposed for violation of the Trust Indenture Act are substantially the same as those contained in the Securities Act of 1933.

To conform to the Act, the indenture must contain certain prescribed provisions, the most important of which are the following:

1. It must name a financially responsible corporate trustee with a combined capital and surplus of not less than $150,000, whose interests do not conflict with those of the indenture security holders. It may also name individual co-trustees.
2. It must provide that where certain defined conflicting interests arise, the trustee must either resign, remove the conflicting interest, or notify security holders, and that the latter possess certain powers of removal.
3. It must require the corporation to furnish the trustee with lists of security holders at stated intervals.
4. It must require the corporate trustee either to make such lists of security holders available to security holders, or to mail communications from security holders to other security holders, or apply to the Commission to be excused from doing so.

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[6] See page 272.

5. It must provide for annual reports and certain interim reports to security holders by the trustee.

6. It must require the corporation to file annual reports with the trustee and to furnish the trustee with (a) evidence of recording of the indenture, (b) evidence of compliance with conditions precedent relating to issuance of additional securities and to other matters of interest to security holders, and (c) certificates of independent engineers, appraisers, or other experts, or opinions of officers of the corporation, as to the fair value of property or securities released from the lien of the indenture, and of securities or property deposited with the trustee as the basis of issuance of securities, the withdrawal of cash, or the release of property or other securities subject to the lien of the indenture.

7. It must require the trustee to notify the security holders of all defaults unless otherwise provided.

8. It must provide that in case of default the trustee shall exercise the rights and powers vested in it with the care and skill that a prudent man similarly situated would exercise.

Registrar and interest-paying agent. In addition to the trustee, there is usually, in the case of bond issues, a registrar and interest-paying agent. The function of the registrar is simply to record the names of the registered bondholders. The trustee often acts as registrar.

In most cases the paying agent is the same party as the trustee and registrar. Sometimes companies serve as their own interest-paying agents, but usually the paying agent is a bank or trust company. Many companies whose securities are traded in New York City or some other large city have a co-paying agent in that city for the convenience of the security holders.

Payment of interest on bonds. To meet the desires of investors, bonds are usually issued in three forms:

1. *Bearer form.* A bond made payable to bearer is called a coupon bond because the interest payments are represented by sheets of coupons attached to the bond. As the interest days approach, the appropriate coupon is "clipped" off by the bondholder and deposited in his bank, which forwards it for collection to the fiscal agent of the company. Such bonds are completely negotiable by delivery. If lost, title will be lost by the owner as soon as the bond gets into the hands of an innocent purchaser. To avoid such a loss, a bond may be issued in either of the following two forms.

2. *Fully registered both as to principal and interest.* Registration consists in placing the name of the holder with his address and the date of registry in a book kept for that purpose by the registrar. The holder of this form of bond has nothing to do except to wait for the interest payment, which is automatically sent to him on every payment date.

3. *Registered as to principal only.* Coupons are attached to the bond

when it is registered as to principal only. The holder must detach the coupons for interest payments and collect them as in 1 above.

Usually bonds are interchangeable; that is, the holder may exchange one form for another. A small fee of one or two dollars may be charged for the exchange.

Maturity dates. The maturity date of a bond is the time fixed in the trust indenture and in the bond for the repayment of the obligation. A maturity of 15, 20, 25, or 30 years is customary for a bond. Bonds have been created with extremely long terms, such as 100 years, but such maturities are no longer common.[7] However, there are still many railroad and several public utility bond issues outstanding with maturity dates subsequent to December 31, 2000. Very few industrial bonds are outstanding with maturities beyond 30 years from the date of issue.

Serial bonds. Some bond issues are arranged to have a certain portion of the debt become due each year. Such bonds are known as serial bonds. In serial bonds, for example, those numbered 1 to 100 will mature in one year, those numbered 101 to 200 in two years, and so on. Usually the series carrying the longest term pays a higher rate of interest than those with the shorter terms. For example, the serial bonds of the City of Worcester, Massachusetts, mature annually from 1957 to 1986. Each year from 1957 to 1960, $225,000 mature. The amount due each year then gradually declines until the years 1981 to 1986 when $75,000 mature each year. The coupon rates are as follows: maturities: 1957, 1.75 per cent; 1958, 1.80 per cent; 1959, 1.90 per cent; 1960, 1.95 per cent; and so on, until the years 1981 to 1986 when the coupon rate is 2.40 per cent.

Serial bonds must not be confused with series bonds; the latter are designated as Series A, B, and so on, and are issued at different times under one large mortgage. They will be discussed in the following chapter. Serial bonds will be mentioned again in Chapter 8, which deals with the extinction of bonded indebtedness.

Callable or redeemable bonds. Most trust indentures created in recent years give the company the right to call bonds issued thereunder before maturity. The call feature, also known as the redemption feature, enables the corporation to pay off the bonds before maturity, if the company can afford to do so, or to refund the bonds by issuing other securities, less costly to the corporation, in their place. These

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[7] Some companies—the Public Service Company of New Jersey, for example—have issued bonds that by their terms are perpetual. These securities, it would seem, are hybrids, having some of the characteristics of bonds and at least one of the characteristics of stock—that is, perpetual obligation. In other cases it is intended that the bonds will not be paid off, but will be refunded. The principles underlying this proposition will be considered in Chapter 7.

and other reasons for wanting to redeem bonds are explained in the chapter on extinction of bonded indebtedness.

Convertible bonds. A convertible bond is one that gives the security holder the right to exchange his bond for some other form of security, usually preferred stock or common stock of the corporation, on a fixed basis described in the trust indenture. The conversion privilege adds a speculative interest to bonds and is given to make them more attractive and salable. The bond is generally a safer investment than the common stock of the company since the price of the bond will generally not fall below the investment value of the security without the conversion privilege. The use of the conversion privilege in bond financing and as a means of liquidating the debt will be discussed in Chapter 8.

Sinking fund bonds. A sinking fund bond is one that imposes upon the corporation the obligation to set aside a certain sum from earnings periodically for the purpose of reducing or retiring the bonded indebtedness. Since the fund is usually turned over to the trustee to be invested "in the same issue," it actually is not a fund but a partial extinction of the debt. Sinking fund bonds will be discussed more fully in Chapter 8.

Research Question

What is the current yield on the following types of bonds?

U. S. Government (taxable)
Municipals (high grade)
Industrials (high grade)
Railroad (high grade)
Public utility (high grade)

Problem

A comparison of the assets of the Bland Company for its two most recent years of operation shows that assets increased from $30,000,000 to $40,000,000 (current capital increased $1,000,000 and fixed assets $9,000,000). This increase was financed by retaining $1,000,000 of earnings, $500,000 depreciation, by increasing accounts payable $500,000, by a five-year installment note of $2,000,000, by a purchase money mortgage of $3,000,000, and by selling stock in the sum of $3,000,000. Which may be termed equity capital and which borrowed capital?

CHAPTER 7

Secured and Unsecured Bonds

Secured and unsecured debt. Creditors may be classified in various ways, the chief categories being secured and unsecured. When a businessman has "good credit," by which is meant that he has sufficient evident earning power to pay his debts, current and prospective, creditors will readily turn over property to him relying on his general ability and proven willingness to pay at the proper time. But when there is any doubt about his ability to pay, and contingencies are likely to arise that may impair his ability to pay on the appointed day, creditors may demand specific security, such as a mortgage on the company's property. Those creditors with a specific lien on property are called secured creditors. All others are unsecured creditors. Whether a creditor is secured or unsecured is important in determining the order in which his claim will be paid, should the debtor become insolvent and hence not have sufficient assets to satisfy all creditors' claims.

Secured and unsecured bonds. Corporate bond issues may be secured or unsecured. A secured bond does not necessarily have greater investment merit than an unsecured bond, because the grade of a bond depends more upon the earnings of the issuer than upon the security pledged to protect it. In general, if earnings are adequate, interest is paid and the question of security never arises. Security is merely a device for giving the bondholders a somewhat stronger position in case of financial failure of the issuer and it becomes important only in case the issuer is unable to meet its interest and other obligations under the bond. Specific pledges of security are important principally in that they determine the relative strength of the positions of the several classes of security holders in the bargaining that takes place when the corporation is reorganized after financial failure.

In business transactions, a corporation may use the ordinary real estate mortgage as security to finance the acquisition of a specific

building or other piece of real property. Or the security it offers may take the form of a general mortgage on all property owned or later acquired by the debtor. Corporate mortgages securing large bond issues are usually of the latter type.

In addition to these two forms of security—the specific and the general mortgage—there is a third kind of security, the so-called collateral trust indenture. Here the security consists of negotiable securities—usually the stocks and bonds of subsidiaries owned by the parent company.

A fourth form of security is the so-called equipment trust arrangement. In this type of financing, the corporation does not purchase the equipment outright and then pledge it as security for a bond issue. Instead, it gets only possession of the equipment; the title to it is held by a trustee, who issues bonds secured by the equipment. The bonds are the obligation of the corporation that is using the pledged property. When the bonds are all paid off, the corporation gets title to the equipment.

Unsecured bonds—those not protected by any lien upon property—are commonly called debentures.[1] The absence of a lien does not mean that a debenture bond is insecure, for, as already mentioned, investment merit does not depend upon a pledge of security. In fact, in many instances it is possible to draw up an indenture for an issue of debentures that gives as complete protection to the buyer as a mortgage bond, assuming that the corporation has no other debt.

We have referred in the preceding paragraphs to the following types of secured and unsecured bonds:

1. Bonds secured by pledge of real property—mortgage bonds.
2. Bonds secured by pledge of personal property—collateral trust bonds and equipment trust bonds.
3. Bonds not protected by any lien upon property—debenture bonds.

In addition, there are bonds that are reënforced by a pledge, guarantee, or promise of some party other than the issuing corporation. These bonds include guaranteed bonds, joint bonds, assumed bonds, and receiver's certificates.

Mortgage Bonds

Definition of a mortgage. A mortgage may be defined as a deed, absolute in its form, but subject to defeasance, given to secure the performance of some act upon the part of the mortgagor (borrower); usually his repayment of a loan made by the mortgagee (lender) at

[1] In England, the term debenture is used to refer to the whole class of bonds; in other words, Englishmen speak of debentures where Americans speak of bonds.

the time of the execution and delivery of the mortgage. Thus, in the usual transaction, the mortgagor borrows money from the mortgagee and gives as security a deed of property. This deed provides that it shall be null and void if at the time appointed the mortgagor repays the loan.

Operation of a real estate mortgage. In mortgaging a piece of real estate to secure a loan, the mortgagor generally gives the mortgagee two instruments, the mortgage [2] and a bond or note. The bond or note evidences the personal obligation of the debtor to repay the loan, and the mortgage evidences the fact that the property is given as security for the repayment of the loan.

Real estate mortgages operate legally in different ways, depending upon the mortgage theory followed in the state in which the mortgaged property is located. Generally, the states fall into two groups: the *title theory* states and the *lien theory* states. The latter group includes a majority of the states. Also, the Uniform Commercial Code follows the lien theory. The basic legal difference between the two theories is that under the title theory the mortgage operates as a transfer of the legal title of the property to the mortgagee (lender), whereas under the lien theory the title to the pledged property remains with the mortgagor (borrower), the mortgagee acquiring a lien, or claim, against the property.

The practical result of the two theories is essentially the same. If the mortgagor defaults in his obligation under the mortgage, the mortgage is foreclosed. Under both the title and lien theories, foreclosure involves court proceedings to satisfy the mortgagor's obligations. In the lien theory states, foreclosure is followed by sale of the pledged property; in the title theory states there is no sale since the mortgagee already has title to the property, which becomes absolute upon foreclosure. Under both theories, the mortgagor is liable on his bond, or note, for any deficiency after foreclosure.

The mortgagor may also give second and third ("junior") mortgages on the same property as security for loans. A second or third real estate mortgage operates in much the same manner as a first mortgage. However, the claims of junior mortgagees are subordinate to the claims of first or senior mortgagees. The senior mortgage, or mortgages, must be satisfied before the junior mortgage.

Illustrations. The operation of a real estate mortgage where the lien theory applies is made clear in the following illustrations:

1. We may assume that *A*, the owner of property reasonably worth \$100,000, mortgages it to *B* for \$60,000. If *A* defaults in the payment of principal and interest to *B*, *B* may foreclose the mortgage.

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[2] A simple real estate mortgage is given in Appendix B, with comments that bring out the essential provisions of a mortgage.

The property is then sold to *X*, but it brings only $50,000. *B* gets the $50,000, and, in addition, a deficiency judgment against *A* for $10,000, since *A*'s personal debt on his bond is in fact $60,000, of which only $50,000 was paid by the foreclosure sale.

2. If *A*, after mortgaging the property to *B* for $60,000, then mortgages it to *C* for $20,000 and then to *D* for $15,000, *B* will be said to have a first mortgage, *C* a second mortgage, and *D* a third mortgage. *B* has a mortgage lien on the property, and so do *C* and *D*, but *C*'s lien is a second lien, subordinate to the first, and *D*'s lien is a third lien, subordinate to the first and second. Assume that, as in 1 above, *A*'s default in payment is followed by foreclosure and sale to *X* for $50,000. In spite of the fact that there are other mortgages and liens, *B* gets the entire $50,000, since he holds the first mortgage which must be satisfied before the other mortgages. In addition, as in 1, he gets a deficiency judgment against *A* for $10,000. *C* and *D* could also hold *A* personally liable for the amounts of the mortgages they hold, if *A* had also given them a bond.

3. If *X*, instead of paying $50,000 as in 2 above, had paid $70,000, this sum would be divided $60,000 to *B* and $10,000 to *C*, but *D* would still get none of the proceeds of the sale, since *B* and *C* must be satisfied first. However, if *X* paid $85,000, this sum would be divided $60,000 to *B*, $20,000 to *C*, and $5,000 to *D*.

Corporate mortgages. Ordinary real estate mortgages, as we have seen, cover specific property. The corporate mortgage, from the standpoint of the property covered by the lien of the mortgage, may be (1) a specific mortgage, or (2) a blanket or general corporate mortgage.

Specific mortgage. Under a specific mortgage, the lien of the mortgage applies to specific property only. Many of the railroad mortgages which have been assumed by the larger railroads upon merger are specific mortgages. For example, the Warren R.R. Co. first refunding 3½'s due 2000 are secured by a mortgage that is a first lien on 18.69 miles of railroad between New Hampshire Junction and Delaware River, N.J. The mortgage was assumed by the Delaware Lackawanna & Western R.R. Co. upon merger of Warren R.R. Co.

Blanket or general mortgage with after-acquired clause. The blanket or general corporate mortgage covers all the property of the corporation (including, in the case of utilities, the special franchises), future earnings, and future acquired property, or, as it is generally expressed, after-acquired property. Most large corporate mortgages are of this type. The purpose of the corporation is to mortgage everything it has, to give the amplest security, and thus to reduce the rate of interest that will have to be paid on the bonds.

In some general corporate mortgages, property not intended to be mortgaged is reserved from the lien of the mortgage. For example, the

mortgage of the Public Service Co. of Colorado, securing the 2⅞'s due 1977, excepts from the lien of the mortgage receivables, cash, securities not specifically pledged, materials acquired for resale, and certain parcels of real estate.

An important distinction between the corporate mortgage and an ordinary real estate mortgage should be pointed out. Default in the payment of interest or principal on the ordinary real estate mortgage would generally result in foreclosure and sale of the property, as described at page 114. In the case of insolvency of a corporation and default under its corporate mortgage, there would rarely be a foreclosure of the mortgage. Instead, the rights of the creditors, including the security holders, would in practically all cases be worked out in a reorganization of the corporation.[3]

Names of secured bonds. There are several expressions popular in financial parlance that are used to indicate the special features or characteristics of mortgage bonds. Frequently they are used in the titles of bond issues to identify them. However, the name of a bond must not be taken as an indication of the nature of the lien or the security of the bond. In other words, the fact that a bond is called a first mortgage bond is no assurance that it actually has a first lien on all of the property of the corporation.

Senior, junior, and underlying mortgages. A mortgage is said to be a junior mortgage when it is subordinate in lien to one or more prior mortgages. Conversely, a senior mortgage is one that is followed by one or more subsequent mortgages. The term "underlying" is applied usually to a small mortgage that has a lien prior to a larger mortgage. This situation usually arises through the expansion of a corporation or through consolidation of several corporations.

The group of diagrams on page 117 will serve to illustrate a typical situation. Let us assume that three companies, 1, 2, and 3, were organized in the same line of business at different times, and in the course of growth placed mortgages *A*, *B*, and *C* upon their respective properties, and that they then consolidated into company 4, the consolidated properties being valued at somewhat in excess of the separate values of the three companies. Later, company 4 placed mortgage *D* on its property. Then corporation 6 was organized as a consolidation of company 4 and company 5, which latter company had no mortgage on its property. Company 6 then placed mortgage *E* on its properties.

Company 4 would probably call the *D* mortgage a *first consolidated mortgage,* because although it was not a first mortgage on the property, it was the first mortgage which the consolidated company put on its consolidated property. Mortgage *E* of company 6 would probably

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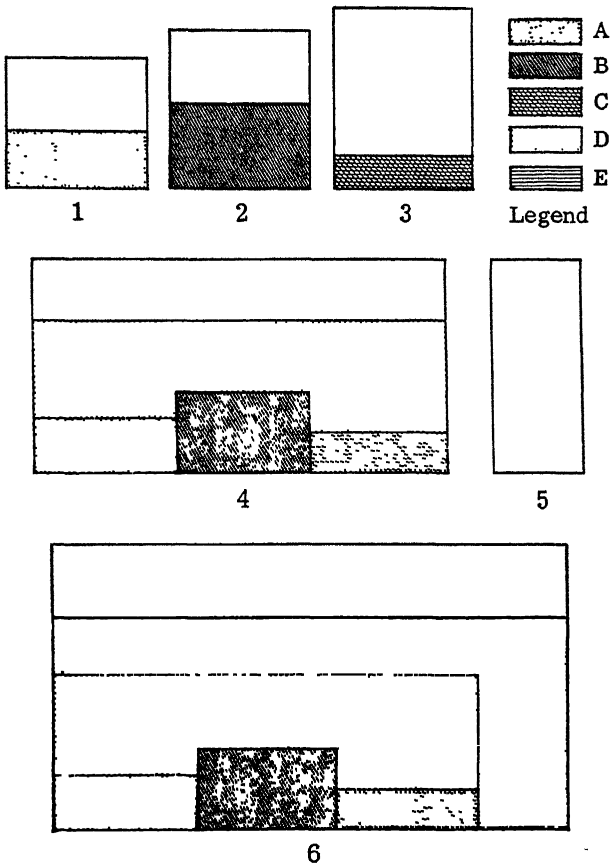
[3] Reorganization is explained in Chapter 27.

be called a *first and consolidated mortgage*. It actually has a first lien on part of the property, that which was brought into the company by company 5. In company 6, mortgages *A, B,* and *C* would be called *underlying mortgages*. Mortgage *D* is junior to mortgages *A, B,* and *C,* and, to a certain extent, senior to mortgage *E*. Because *E* has a direct first lien on a part of the property—probably an important part of the whole company—it would hardly be called a *junior mortgage*. The term *general* would be more appropriate and would more frequently be used.



Methods by Which Successive Mortgages Are Imposed on Consolidated Properties.

Closed-end, limited open-end, and open-end mortgages. Corporate mortgages covering the entire property of a company may be (1) closed-end, (2) limited open-end, and (3) open-end.

Closed-end mortgages. If the entire issue of bonds secured by a mortgage has been disposed of, so that if more bonds are to be issued and secured by mortgage on the same property they must come under the lien of a subsequent mortgage, the earlier mortgage is said to be closed. In case of foreclosure, and in the absence of a special subsequent agreement, all the bonds under the mortgage first issued must be treated alike and must be paid in full before bonds under the later mortgage can participate in the proceeds of the property.

Limited open-end mortgages. Under most modern corporate mortgages, provision is made for future financing. The mortgage is usually a limited open-end mortgage. This means that the equitable rule that "priority in time gives priority in equity" is waived and that all bonds issued under the mortgage, whenever issued, share alike in the proceeds of the foreclosure. The term "limited" is used, since a stated amount of indebtedness may be ultimately secured by the mortgage, but this limit cannot be exceeded.

Thus, if a company knew that it would need $4,000,000 in the next two years, and later would use $6,000,000 for other additions, it would not execute a mortgage now for $4,000,000 and sell the bonds thereunder, and later execute a mortgage for $6,000,000, for if it did that, the $6,000,000 issue would have a subordinate lien; the holders of the bonds secured by it would not be entitled to share in the property until the $4,000,000 issue had been paid off. Consequently, under such an arrangement the second mortgage bondholders would demand a high rate of interest. The company therefore would execute a limited open-end mortgage for $10,000,000, providing that when bonds in addition to the first $4,000,000 are issued they will share *pari passu,* that is, alike with, the $4,000,000 first issued. Thus, if an additional $1,000,000 were issued, say in the third year, the situation would present a first mortgage of $5,000,000 and not a first mortgage of $4,000,000 and a second mortgage of $1,000,000. When the whole $10,000,000 are issued, the mortgage will be said to be closed.

Very frequently, subsequent events show a rate of growth much more rapid than was expected and the limited mortgage proves a stumbling block to much larger financing. In such an event two methods of procedure are open. One is to negotiate with the holders of the bonds to refund their holdings in a much larger issue. If all the bondholders consent to the refunding, the old, relatively small mortgage is extinguished and the new, larger mortgage provides a first lien to cover the new bonds to be sold. If, on the other hand, the bondholders will not consent, the new mortgage may be issued, and a clause may be inserted in it providing that no more bonds may be issued under the terms of the earlier mortgage, which, though it remains a first mortgage, is limited in size to less than was originally contemplated.

Open-end mortgages. The open-end mortgage is one that authorizes the issuance of bonds in any amount under the provisions of the mortgage. As in the limited open-end mortgage, all bonds issued under the mortgage share alike in the proceeds of foreclosure. Where protection is afforded to prevent the issuance of additional bonds without additional security, there seems to be no reason why mortgages should not be made open-end.

Need for restrictions on additional issuance in limited and open-end mortgages. If a company could issue additional bonds from time to time under cover of a limited open-end or open-end mortgage, the earlier purchasers of bonds would be injured unless, as new bonds were issued, the security itself were in some way increased. Let us demonstrate by diagram the need for protecting old bondholders under such mortgages.

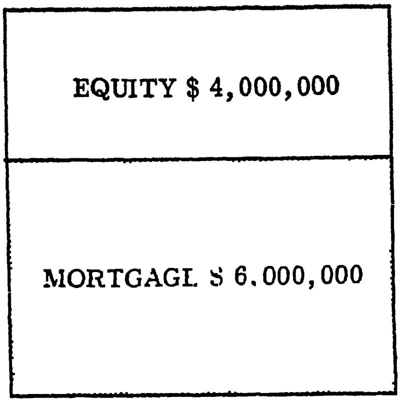


Figure 1.

Assume that a company with property A, which is worth $10,000,000, has issued $6,000,000 of bonds under a $30,000,000 limited open-end mortgage. The rectangle in Figure 1 represents property A, and the shaded portion the mortgage. The equity now is equal to 40 per cent of the security. If you had purchased one of the $6,000,000 worth of bonds with a face amount of $1,000, there would be property of a value of $1,667 to protect your bond. If more bonds were issued without increasing the value of the property, the amount of security behind your bond would diminish. Thus, if $2,000,000 were issued, the security ratably behind your bond would be worth only $1,250.

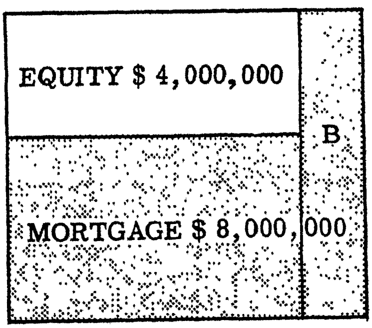


Figure 2.

Suppose, on the other hand, more property were acquired, say $2,000,000 worth, represented by B in Figure 2. Suppose further that this property were bought with $2,000,000 of bonds of the same issue. The result now would be that a security of a total value of $12,000,000 was protecting $8,000,000 of bonds. The equity would be only 33⅓ per cent and each bond would be protected by property worth only

$1,500. The equity has fallen from 40 per cent to 33⅓ per cent and the security behind the bond has fallen from $1,667 to $1,500. Evidently some plan must be devised to protect investors who buy bonds issued under an open-end or a limited open-end mortgage. The plan is found in "restrictive provisions." [4]

Types of restrictive provisions. The restrictive provisions commonly found in limited and open-end mortgages are of the types mentioned below. Frequently several of them are included in the indenture.

1. *Earnings applicable to payment of interest must equal a certain amount.* This provision states that bonds shall not be authenticated for issue if the net earnings applicable to the payment of interest for twelve consecutive months out of the fifteen preceding are not equal to or greater than two times [5] the amount of the bond interest that will be payable when the proposed new issue is made. Thus, if a company has $6,000,000 bonds outstanding and wishes to issue $1,000,000 additional bonds bearing interest at 5 per cent to finance the construction of property, the amount of interest required, assuming the $1,000,000 to be issued, will be $350,000 a year. Unless, then, its net earnings are equal to or in excess of $700,000, the new bonds cannot be issued.

2. *Issue of bonds restricted to a certain proportion of new property.* This provision says in effect that no bonds shall be authenticated by the trustee unless new property is acquired by the company to thicken the equity, that is, to increase the security. The usual provision is that bonds may be issued for an amount not exceeding 60 or 70 per cent of the cost or value of permanent improvements, additions, or extensions, or any new or additional property constructed subsequent to the date of the mortgage. Thus, in the open mortgage of the Public Service Company of New Hampshire, one of the limitations on the creation of additional debt permits the issuance of bonds up to 60 per cent of the net amount of additional property subjected to the lien of the indenture (after deducting from such 60 per cent the principal amount of underlying bonds secured by mortgage on such additional property).

3. *Bonds must bear a certain relationship to stock outstanding.* Such a limitation is found in the Louisville & Nashville R.R.'s first and refunding mortgage, under which various series of bonds have been issued. The total authorization is limited to an amount which, together with all of the outstanding prior debts after deducting therefrom the

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[4] Restrictive provisions are sometimes called "escrow agreements" because they recite the terms on which the unissued bonds held by the trustee in escrow can be released from the escrow.

[5] This multiplier, of course, may be higher or lower; two, however, is a very usual multiplier.

bonds reserved under provisions of the mortgage to retire prior debts at maturity, shall never exceed three times the then outstanding capital stock.

4. *Net quick assets must bear a certain relationship to fixed charges.* Like the preceding restriction, a provision that new bonds are not to be issued if the aggregate fixed charges after they are issued exceed a certain proportion of the net quick assets, is designed to protect interest on outstanding bonds. Net quick assets comprise the total of cash, accounts and notes receivable, and sometimes inventories, less all current liabilities. This is but another way of saying that net quick assets must be sufficient to pay the fixed charges, including the interest on the bonds proposed to be issued, for a certain number of years. Thus, if the net quick assets of a concern are $1,000,000 and bonds outstanding amount to $10,000,000 and it is proposed to issue $5,000,000 more, the net quick assets would be sufficient to pay interest on the bonds, assuming they were 5 per cent bonds, for one and one-third years. This ordinarily is not sufficient. Similar to this restriction is the one calling for maintenance of a certain ratio between current assets and current liabilities. Usually restrictions of this kind carefully define what is meant by net quick assets, or current assets and current liabilities.

Dividend restrictions to protect security of bondholders. Dividend restrictions may be required of some companies when the terms of the issue are worked out with the investment bankers or an institutional purchaser. One such restriction is illustrated by the open mortgage of the Ohio Light & Power Co., securing the first 2⅞'s due 1977, which restricts the payment of dividends on common stock to earned surplus accumulated subsequent to December 31, 1943. In addition to this type of restriction, an additional limitation was included in the Cosden Petroleum Corp. mortgage securing its first sinking fund 3¾'s due 1956. The company could not pay dividends unless immediately thereafter the current assets were at least twice the current liabilities.

Another method of limiting dividends is through a covenant by the company that the net assets shall always be at least a certain amount in excess of the par value of stock outstanding. In other words, the company agrees to maintain a minimum surplus.

Series bonds issued under limited and open-end mortgages. Blanket mortgages under which issues are made from time to time frequently provide that the directors may decide, as each issue is made, the terms of the bond, the rate of interest, the form of the bond—that is, whether it is to be registered, or coupon, or interchangeable—and other features such as redemption and conversion. The bonds, in other words, are authorized to be issued in series. All of the bonds of one and the same series are identical as to the date of maturity, rate of interest,

place or places of payment, the terms of redemption, if redeemable, and as to the privilege, if any, of convertibility into stock. However, with respect to these and other features, the bonds of one series may differ from those of another series. Usually, no new series can be issued to mature prior to the date of maturity of any of the prior lien bonds mentioned in the mortgage or any bond issued and then outstanding, secured by the mortgage. Each series is identified by a letter. Thus, the Pennsylvania R.R. has issued under its open-end general mortgage the following series of bonds: Series A, 4½'s, due 1965; Series B, 4's, due 1968; Series D, 4¼'s, due 1981; Series E, 4¼'s, due 1984; Series F, 3⅛'s, due 1985; Series G, 3's, due 1985; and Series H, 4¼'s, due 1986.

Prior lien bonds and adjustment bonds. A company may have placed several mortgages and may be in need of more funds. Even the mortgage bondholders may recognize that new money is necessary to keep the business going and thus protect the interests of everybody. If the bondholders will consent, a new mortgage may be placed on the property prior in lien to all other mortgages, or with the consent of junior bondholders, prior to the junior mortgages. Bonds issued under such prior lien mortgages may then be called *prior lien bonds.* Prior lien bonds are rare, because it is difficult to get the consent of bondholders having claims under older mortgages.

Sometimes a corporate mortgage provides originally that other bonds under other mortgages may be issued subsequently, but with a lien prior to that of the former mortgage. Such a mortgage is likely to be made in case of reorganization or of readjustment of the company in time of difficulties, and the bonds issued under it will therefore be called *adjustment bonds.*

Effect of after-acquired clause and how it is avoided. As has already been explained, the effect of the after-acquired clause is to subject after-acquired property to the lien of a previously issued mortgage. Where the mortgage containing an after-acquired clause is open-end or limited open-end, and there are sufficient unissued bonds to enable the corporation to acquire additional property under the lien of the mortgage, the after-acquired clause may create no problem. But if the company has a closed-end mortgage with an after-acquired clause, it may have trouble financing the acquisition of the new property with a bond issue that is secured by another mortgage on the newly-acquired property. The new bonds would not be rated very high, and hence would have to bear a high rate of interest, because the lien of their mortgage would be subordinate to that of the original corporate mortgage, which lien, by virtue of the after-acquired clause, would rest on the new property as soon as it is acquired.

One method of avoiding the difficulty created by the after-acquired

clause is the refunding mortgage discussed at page 124. Other methods of evading after-acquired property clauses are:

1. Purchase money mortgage.
2. Subsidiary company to acquire new property.
3. Lease of new property instead of direct purchase.
4. Consolidation with other companies.

Purchase money mortgage to avoid after-acquired clause. A purchase money mortgage is one given in whole or part payment of the price of the property on which it rests. Thus, if *A* buys property *X* from *B* for $15,000, paying $5,000 cash and giving back a mortgage on property *X* for $10,000, this mortgage will be called a purchase money mortgage. What, it may be asked, is the peculiar nature or effect of a purchase money mortgage? What, in effect, have the parties to this transaction done? *B*, we may suppose, with his right hand has conveyed the title to property *X* to *A* by giving *A* a deed; with his left hand *B* has taken back the legal title to property *X* by means of the mortgage. What has *A* really got? Nothing but the equitable title —the equity of redemption. And now if *A* happens to be a corporation with an outstanding general mortgage containing an after-acquired clause, what will be the relative positions of the general mortgage and the purchase money mortgage with respect to property *X*? Is it not evident that the purchase money mortgage has the first lien? The after-acquired clause, to be sure, operates as a mortgage on *X*, but only on so much of *X* as *A* owns, which is the equity of redemption behind the purchase money mortgage.

Subsidiary to acquire new property. Let us suppose that company *A* has a mortgage of $5,000,000 on its property, in which mortgage is found an after-acquired clause, and that *A* wishes to acquire property *M* with the proceeds of bonds secured by *M*. Company *A* may organize a subsidiary, *S*, to take over *M* and to issue bonds for this purpose. In this case the stock of *S* would have to be deposited with the trustee under the mortgage because of the after-acquired clause contained in that mortgage. But *S* could acquire property *M* through the sale of stock to the public, or it could issue bonds which would have a first lien on *M* since they would be the first bonds issued by the corporation owning the property.[6] The after-acquired clause of company *A* would have no effect since the property really never was acquired by *A*.

Avoiding the after-acquired clause by a lease. The lease arrangement avoids the effects of the after-acquired clause by permitting the company to obtain the use of property without taking title to it. This

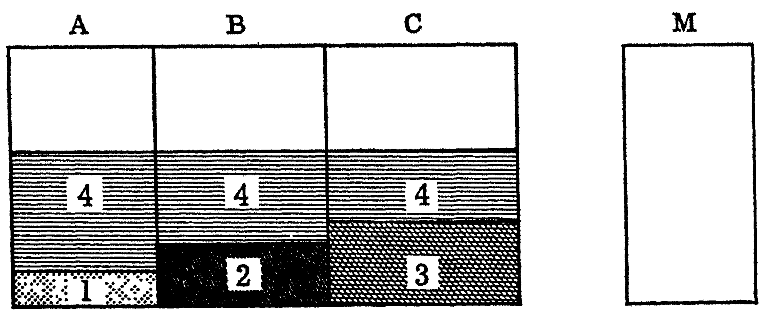
[6] The bonds would undoubtedly have to be guaranteed by the parent corporation to give them marketability. Guaranteed bonds are discussed at page 135.

method is used principally in connection with the financing of railroad equipment. We shall explain the process fully at page 128 when we explain equipment trust obligations. The lease method has also been used by railroads to acquire additional rights of way free of mortgage liens that would otherwise accrue under the after-acquired clauses of existing mortgages.

Avoiding the after-acquired clause by consolidation. After-acquired clauses are sometimes entirely nullified by a consolidation of the issuing company with another company. Thus, if corporation *A* issues a mortgage with an after-acquired clause and then *A* consolidates with *B*, as far as that after-acquired clause is concerned *A* is no longer in existence—its existence has been lost by the consolidation. It therefore cannot acquire property to which the lien of its mortgage can attach. Sometimes a clause is inserted in the mortgage to guard against this, but to discuss such a clause would lead us into legal intricacies beyond the purview of this book.

The refunding mortgage. Difficulties and problems have often arisen in corporation financing from piecemeal growth and from the practice of using after-acquired clauses in corporate mortgages. Let us make the problems more concrete by taking an imaginary example.

We shall suppose that company *ABC* (see diagram) is a consolidation of three companies, *A*, *B*, and *C*, each of which had a mortgage on its property before consolidation. These mortgages are represented respectively by the portions of the diagram designated 1, 2, and 3, and are in amount, respectively, $1,000,000, $2,000,000, and $3,000,000. *ABC*, shortly after consolidation, issues bonds under mortgage 4 which permits the issuance of bonds up to $10,000,000. Various additions have been made to the property, entailing the issue to date of $6,000,000 of the number 4 bonds. Mortgage 4 has an after-acquired clause. The company now wishes to acquire property *M* at a cost of $5,000,000. Evidently this cannot be done with number 4 bonds since only $4,000,000 are left.



Financing Acquisition of Property.

What should the company's objectives be in overcoming this difficulty?

1. It should try to consolidate its underlying issues. They were placed on the property when the companies were new, before their credit was well established, and at a time, therefore, when comparatively high interest rates had to be paid.

2. It should try to get property *M* with funds bearing the lowest interest rate possible.

3. It should provide means for financing expansion in the future at reasonable cost.

All of these objectives can be accomplished by a large, so-called first refunding mortgage.[7] If the company will abandon mortgage 4 (or provide in a new mortgage that mortgage 4 shall be closed at $6,000,000) and then execute a new, reasonably large mortgage—sufficiently large to take care of all probable needs for, say, from thirty to fifty years, if that is to be the term of the new mortgage—objective number three stated above will be accomplished.

How the refunding is effected. To continue the illustration, the *ABC* Company would sell the entire new consolidated issue of bonds to investment bankers and with the proceeds would redeem the outstanding bonds. Announcement would be made to the old bondholders that their bonds were being called and would be paid for in cash. If the bonds were not turned in, they would no longer bear interest, but cash would be held for their redemption. The new bond issue is sold by the investment bankers to investors. Any old bondholder could purchase these bonds with the proceeds he received when his bonds were redeemed.

This method of refunding would generally be used if the outstanding bonds were callable. Most modern trust indentures under which bonds are issued contain the call privilege. Usually the call price is more than par and the premium is considered as part of the cost of effecting the refinancing. Assuming that the new bonds have the same maturity and interest rate as the old bonds, and that the new bonds are sold at 100, the cost to the corporation of the refinancing would be the redemption premium and the investment bankers' commission. These costs would be offset by economies that would result from consolidating a number of small issues.

Collateral Trust Bonds

Collateral trust bonds. A corporation may create an issue of bonds secured entirely by a pledge of other securities. Because the bonds is-

[7] If in addition to mortgage 4, any of the underlying mortgages were refunded, the bonds would probably be called "first and refunding."

sued are secured by collateral held by a trustee, they are known as collateral trust bonds. Sometimes leaseholds, rents, franchises and patents are offered as collateral in addition. The primary purpose of the pledge of the securities and other collateral is to put it in the power of the trustee to reimburse the bondholders for the money they loaned the corporation should the corporation fail to pay the bond obligation when it becomes due.

Collateral trust bonds are issued in much the same manner as mortgage bonds. The corporation's pledge ordinarily takes place by transfer of actual possession of the personal property pledged to the trustee. The trustee, within the limitations of the trust indenture, holds the pledged property in trust first for itself, but also for the benefit of the bondholders whom it represents, and for the pledgor, the corporation.

Certain reservations are customarily made, namely, (1) that as long as the pledgor (the corporation) is not in default it shall be entitled to the income derived from the pledged securities, and (2) until default the trustee shall give proxies to the company with respect to pledged stock. The proxies enable the corporation to elect directors of its own choosing for subsidiaries whose stock it may have pledged.

The arrangement leaves the trustee owner of the securities, but for the benefit of the bondholders, subject to the temporary rights of the corporation enumerated above, and to the corporation's right ultimately to get back the pledged securities by paying off its obligation. If the corporation should default, the trustee can enforce its claim against the pledge by simply asserting its right of ownership. It may revoke the proxies and may demand direct payment to it of dividends and interest paid by the companies with respect to the pledged securities. Moreover, since the trustee becomes an actual bondholder, should there be a default in payment of interest on the pledged bonds, the trustee may proceed against the defaulting corporations to the same extent as the other bondholders.

Kinds of securities pledged. The kinds of securities usually pledged to support collateral trust bonds are:

1. *Bonds of controlled subsidiary companies.* A parent or holding corporation may use the bonds of several of its small subsidiary corporations as security for an issue of collateral trust bonds. These pledged bonds may have come into the possession of the corporation in various ways. Sometimes they are bonds that the parent has received for advances made to the subsidiaries. In that case, the proceeds of the collateral trust bonds furnish the corporation with the cash that it has advanced to the subsidiaries. The collateral trust bonds are marketable on better terms than the bonds of the small subsidiaries would be, if they could be marketed at all.

2. *Stock of controlled subsidiaries.* Pledged collateral sometimes consists entirely or partly of the stock of controlled subsidiary companies. For example, the Philadelphia Co. collateral trust sinking fund 4¼'s due 1961 are secured by a pledge of 2,040,000 shares of Duquesne Light Co. common stock.

The collateral trust issue may originate with the acquisition of a new subsidiary company. Let us suppose that company *A* wishes to acquire company *S*. How may *A* do it with little expenditure of its own funds? *A* may simply borrow enough money from a bank to pay for a controlling interest in the stock of *S*, then deposit this stock as collateral to secure an issue of collateral trust bonds, and with the proceeds of these bonds repay the loan. Since it is customary that all loans shall be secured by collateral whose value is in excess of the loan, part of the money required, in this instance, would probably come from the surplus earnings of *A*.

3. *Mortgage bonds of the issuing corporation.* A corporation may have an open-end mortgage under which bonds could still be issued. Those bonds, however, may carry a higher interest rate than is necessary for the condition of the market, or they may be for a longer term than is desirable for the new financing. In that case a new collateral trust issue may be created and the mortgage bonds pledged as security. The collateral trust bonds would be as well secured as the outstanding mortgage bonds. In fact, if the face amount of the pledged bonds is greater than the par value of the collateral trust bonds issued against them, the collateral trust bonds would indeed enjoy an advantage over the mortgage bonds in case of trouble.

The Chicago, Burlington, & Quincy R.R. Co., first and refunding 4½'s, due 1970, are an example of an issue secured by the pledge of various kinds of securities. The collateral consists of the company's own general mortgage 4 per cent bonds; common and preferred stock in bridge, depot, and terminal companies; common stock in the Colorado & Southern Ry. Co.; and common stock of the Davenport, Rock Island & North Western Ry. Co.

Quality of collateral trust bonds. The quality of collateral trust bonds, like any other bonds, is judged in the first place by the earnings of the corporation that issued them. When the earnings or general credit of the issuing corporation is impaired, the bonds may still be buttressed by the collateral that secures them. How strong that buttress is depends upon the adequacy and stability of the earnings of the corporations whose securities have been pledged. For example, if the collateral consists of common stocks of a company with poor earnings, which has an issue of bonds or preferred stock outstanding, the collateral will obviously not strengthen the collateral trust bond. Also, to have real value as collateral, the pledged securities must have

marketability. Collateral trust bonds as a class have not enjoyed a good investment record.

Equipment Obligations

Equipment trust bonds. Equipment trust bonds (sometimes called notes or certificates) are usually issued to finance the purchase of movable equipment, especially rolling stock. A railroad corporation, for example, has several outstanding bond issues, secured by mortgages with clauses covering after-acquired property. It would therefore ordinarily not be able to purchase additional equipment and to pledge it as security for the purchase price without paying a very high interest rate on the loan because the holders of the prior mortgages, under the after-acquired clauses, would have liens superior to that of the new pledgee. For this reason, the corporation does not purchase the equipment outright and pledge it to secure the purchase price. Instead, it rents the equipment, thereby getting the use of it but not the title to it. Since the corporation does not have title to the equipment, it cannot become subject to the lien of any mortgage having an after-acquired clause. Now let us see how the lease arrangement, which is known as the Philadelphia plan, is carried out.

An agreement known as an equipment trust agreement is made between a trustee, usually a trust company, the railroad company, and the car company that is selling the rolling stock. This agreement provides: (1) The title to the cars is to be held in trust by the trustee.[8] (2) Equipment trust bonds are to be issued by the trustee and sold to the public. The proceeds will create a fund to meet the major part of the cost of the equipment. These bonds are to be issued in series so that a portion of them will mature each year. Usually the period is ten or fifteen years. The bonds are the obligation of the trustee, not of the railroad, but they are guaranteed both as to principal and interest by the railroad. (3) The purchasers of the equipment trust bonds are to have as security the actual equipment, called the trust equipment.

Simultaneously, a lease agreement is made between the trustee and the railroad, under which the railroad gets the use of the cars and pays rent therefor. The rental payments are the source of the funds which will be used to pay interest on the bonds and the principal of the maturing bonds. The rent consists of: (1) An initial payment, usually 20 per cent or 25 per cent of the purchase price of the equipment. This payment has the effect of establishing an equity in the equipment for

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[8] The equipment trust agreement will probably provide that a metal plate must be fastened securely to the car with a statement thereon that the car belongs to the trust company; the railroad's interest may be indicated by some word, such as "Erie," painted on the side of the car.

the railroad. Also, it means that the equipment trust bond issue will be in an amount equal to the difference between the cost of the equipment and the initial payment. (2) Semi-annual payments equal to interest on the outstanding bonds. (3) Annual payments sufficient to pay off the bonds maturing each year. (4) Taxes and expenses of the trustee. When the last of the maturing bonds are paid off, the railroad company will pay a nominal consideration, say ten dollars, and the trustee will deliver title to the equipment to the railroad company.[9]

A similar plan provides for a conditional sale instead of passing title to the trustee and leasing by the trustee to the railroad. Some local statutes make the conditional sale preferable. Under the conditional sale plan, frequently used when the securities are to be held by institutional investors rather than the general public, the manufacturers make a conditional sale of the equipment to the railroad under a contract providing for a down payment, and annual or semi-annual payments over a period of years to cover the balance of the cost plus interest on the unpaid balance. The manufacturer then assigns its rights under the contract to a trustee, generally called an "agent," who issues participation certificates and uses the proceeds to pay the manufacturer. Title is held by the agent until the entire purchase price is paid.[10]

The effect in each case, whether the Philadelphia plan or the conditional sale agreement is used, is that the actual title of ownership remains with the trustee until all the bonds are paid off. The method of using the lease or conditional sale agreement to finance the acquisition of equipment is illustrated in the diagram. *R* is the railroad company, *T* the trustee, and *C* the car company.

To clarify the financing, let us assume that railroad *R* wishes to buy six hundred cars and eleven electric locomotives from car company *C*, the total consideration to be $4,800,000. The railroad will pay an

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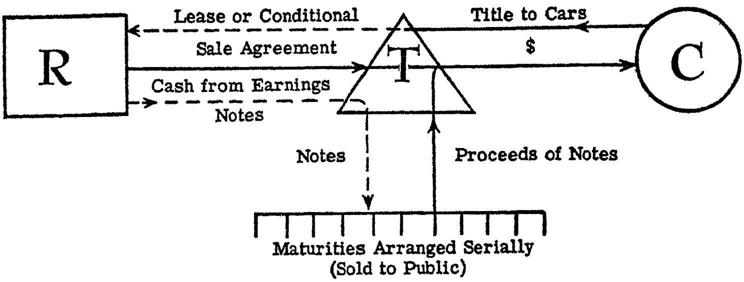
[9] A variant of the Philadelphia plan has been developed which eliminates the car company that is selling the rolling stock, and combines the trust agreement and lease in one Equipment Trust Agreement. See Leonard D. Adkins and De Forest Billyou, "Current Developments in Railroad Equipment Financing," *The Business Lawyer*, April 1957, p. 207.

[10] A third method of purchasing rolling stock is the equipment mortgage plan. The issuance of equipment obligations under this plan is similar to the issuance of mortgage bonds. Because of certain legal obstacles, this plan is seldom used.

It should also be noted that a recent trend in railroad equipment financing does not involve the use of the equipment bonds or certificates at all. An investor purchases the equipment and then leases it directly to the railroad. The advantages of this leasing plan, as it is called, are (1) a possible larger tax deduction for the railroad and (2) no need for a down payment. These advantages must be balanced, however, against the fact that the railroad will never acquire title to the equipment. See Leonard D. Adkins and De Forest Billyou, "Current Developments in Railroad Equipment Financing," *The Business Lawyer*, April 1957, p. 207, and "Acquisition of Industrial and Commercial Equipment Through Leasing Arrangements," *The Yale Law Journal*, April 1957, p. 751.

initial rental of approximately 20 per cent or $1,000,000. The trustee will issue equipment trust bonds in the amount of $3,800,000 (3,800 thousand-dollar bonds) maturing, say, over a period of ten years. Each half-year the company will pay the trustee rent equivalent to the interest on the outstanding bonds. Each year it will turn over to the trustee as rent sufficient cash to pay off 380 bonds, each having a face value of $1,000. When the last 380 bonds are paid off, the company will get title to the equipment.



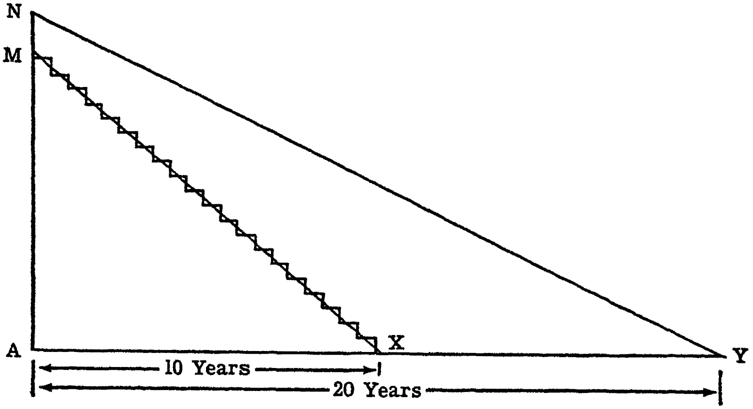
Acquisition of Rolling Stock Through Issuance of Equipment of Trust Notes.

Oil companies, tank car companies, and tank line companies, as well as other enterprises having large amounts of capital invested in movable and salable equipment, have made extensive use of the Philadelphia plan of equipment trust obligations. The equipment trust plan was applied to the financing of the purchase of transportation flying equipment for the first time in 1939. The equipment trust notes in this instance matured over a period of five years. The plan is the same as that described for railroads. Title to equipment remains with the trustee and is leased to the company in need of the equipment.[11] The lessee undertakes to pay sufficient rental to pay interest on the notes and the principal of each series at maturity.

How equipment trusts satisfy all parties. In the above described transaction four parties are involved: the car company, the trustee, the railroad, and the investing public. The car company gets what it desires: cash upon delivery of the cars; the railroad attains its object: the use or possession of the cars and ultimately the title thereto; and the investors get what they want: the security of the equipment itself. As we have seen, the trustee holds the equipment and the lease in trust for the benefit of the bondholders, and the railroad company does

[11] Methods of financing air transportation equipment are not as well settled, at this time, as the financing of railroad equipment. The possibility of loss through wreck and the public liability associated with air transportation discourage the financing institutions from retaining title to the equipment. Air transport companies make considerable use of the chattel mortgage.

not acquire title to the cars until the public has been removed from the situation by the redemption of the equipment trust bonds.



Increase in Equity Behind Serial Equipment Trust Notes as Issue Approaches Total Redemption.

Why equipment trust bonds are good investments. The diagram on this page will indicate why equipment trust bonds are usually considered good investments. On the horizontal axis, *AX* measures the ten years during which the notes will remain outstanding, and *AY* measures the life of the equipment.[12] On the vertical axis, *AN* represents the original value of the equipment (for example, \$4,800,000), *AM* represents the original amount of bonds outstanding (\$3,800,000), and the distance *MN* represents the original equity behind the bonds. The line *MX* is a smoothed curve representing the decrease in the amount of bonds outstanding, and the line *NY* represents the depreciating value of the equipment, which is in this case supposed to be reduced not to junk value, but to nothing, when *Y* is reached. It will be noticed that not only does the space between *NY* and *MX* increase absolutely, but that it increases very rapidly relative to the bonds outstanding as the number of bonds outstanding decreases.

Should the railroad company default in the payment of interest or in the payment of the sum necessary to redeem a semi-annual installment of principal, the trustee will simply declare the lease void and will make a new lease to some other railroad.

On account of the economic and legal position of the holders of

[12] These periods are likely, in ordinary cases, to be ten years and twenty years, respectively. The mortgage securing the notes provides that if any of the equipment is damaged, it must be immediately repaired, and if destroyed, must be replaced by other and similar equipment or the money-equivalent thereof placed in a fund securing the outstanding equipment notes.

these equipment trust bonds, defaults are almost entirely unknown. If a railroad fails and a receiver is appointed, he will usually apply to an equity court for authority to continue making the payments on these equipment trust obligations as they mature.

Unsecured Bonds

Unsecured bonds—debentures. A bond issued without security is simply a promise of the borrower to pay a certain sum of money at a stipulated time and place, with interest at a fixed rate. As previously indicated (page 113), bonds unprotected by any specific lien upon property are commonly called debentures, and are often referred to as general credit bonds. The bond issue is made under a trust deed, which distinguishes the debenture from the ordinary note of a corporation.

Debentures are a relatively new type of bond. They were not used in this country before the Civil War, and did not come into prominence until after 1900 when indentures were first executed for the protection of such bondholders. Although mortgage bonds still predominate in the utilities field, the use of debentures, instead of mortgage bonds, has steadily increased in industrial corporations. The issuance of new mortgage bonds is expensive, and, as we have seen, complicated. Through the protective provisions of the trust indenture, unsecured bonds can be made just as attractive to the investor as mortgage bonds.[13]

Various factors such as outstanding bonded indebtedness of the corporation, its credit standing, market conditions, the nature of the company, and the like, determine whether the corporation will issue secured or unsecured bonds. From the individual investor's viewpoint, whether a bond is secured or unsecured is not always important; the safety of the investment, in the last analysis, depends upon the company's ability to pay and not on the right to foreclose a specific lien. The supposed rights of secured bondholders often disappear when a business fails. Frequently, the pledged property has value only to a going concern, and actual foreclosure rights are not exercised. For example, foreclosure rights were not exercised on Interborough Rapid Transit 7's until seven years after default on principal. When the courts do permit foreclosure, the value of the property is usually well below the amount of bonded debt and there are long delays before settlement is worked out among the creditors. As a practical matter, default on

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[13] Mortgage bonds are still predominant in the utilities field because foreclosure rights have more meaning in that field, and because it is fairly simple for utilities companies, most of which have an existing mortgage bond indenture, to continue issuing additional series of bonds under the same mortgage. See Charles C. Glavin, "Corporate Finance Developments: Characteristics and Changes," *The Commercial and Financial Chronicle,* September 6, 1956, p. 3.

a debenture bond may precipitate receivership and reorganization just as default on a secured bond. At any rate, the trustee would be entitled to recover judgment against the company and take action to collect the judgment out of the property interests and rights of the company by sale or otherwise.

Debenture bonds of strong profitable companies are thus frequently rated on a par with the mortgage bonds of other strong companies, and much higher than the secured bonds of weak companies. However, a mortgage bond of a weak company will be superior as an investment to the debenture bonds of the same company, for secured creditors come ahead of the unsecured creditors in case of insolvency.

Who issues debentures. Debentures are issued by corporations in the following categories:

(1) Corporations that have a relatively small percentage of tangible assets and would therefore be unable to issue secured bonds. Service businesses are in this category. The Commercial Investment Trust Financial Co., one of the largest installment finance companies, has an outstanding issue of 2⅝ per cent debentures due in 1959.

(2) Corporations that have unquestionable credit ratings. A company in this position, like Standard Oil of New Jersey, R. H. Macy & Co., and many others, does not have to resort to mortgage bonds to make its securities acceptable to the investing public. It can easily market unsecured bonds. Whereas over the years the public has come to expect the larger industrials to issue debentures, and railroads and utilities to finance with mortgage bonds, strong companies in all fields have used debentures to obtain new capital. For example, Union Pacific Railroad Company has outstanding $44,493,000 of debenture 2⅞'s issued in 1946 and due in 1976. The proceeds of these bonds were used to redeem an outstanding issue of debentures that paid 3½ per cent. The funded debt of the American Telephone & Telegraph Company consists entirely of debenture bonds.

(3) Corporations that have mortgaged all their available assets and therefore must use debentures to obtain funds. Unsecured bonds offered by such low-credit companies carry a high rate of interest to compensate for the risk.

Protective provisions. Every trust indenture under which debenture bonds are issued contains some provisions, or restrictions, designed to protect the investment of the bondholders. These provisions are equally important to the corporation, for its objective is to afford protection to its bondholders without jeopardizing its own freedom to expand and manage the corporation for the benefit of its stockholders. Most modern indentures include a provision permitting the corporation, with the consent of a fixed proportion of the bondholders, to modify the restrictive provisions. The modification privilege is a pre-

caution against future embarrassment in financing the needs of the business. The three most common types of provisions that aim to maintain the position of the debentures are:

1. *Covenants regarding future mortgages or pledges of property.* Although there is usually no denial of the right to mortgage or pledge property, often the limitations constitute a deterrent. A common provision gives the debenture holders the same privileges, guarantees, and security as are given to the holders of any secured bonds issued subsequent to the debentures. The indenture under which the Firestone Tire and Rubber Co. 3 per cent debentures due 1961 are issued provides that if any mortgage bonds are issued in any amount greater than 2 per cent of consolidated tangible assets, the debentures will be secured by the same mortgage.

2. *Restrictions against additional indebtedness.* Another method of restricting further borrowing is to prohibit the creation of additional debt unless earnings bear a certain relationship to the amount of interest that will be payable when the additional indebtedness is incurred. Sometimes, in addition, net tangible assets must be a certain number of times greater than the funded debt. Thus, the Hudson Pulp and Paper Co. 3½'s due 1966 provide in the indenture that except with the consent of two-thirds of the debenture holders no additional debt can be created unless (a) average earnings for the four previous years and (b) earnings for the immediately preceding fiscal year, equal at least four times the anticipated annual interest charges. Also, tangible assets plus proceeds of the proposed issue must equal 2¾ times the funded debt.

3. *Dividend restrictions while debentures are outstanding.* Limitations on dividend payments seek to protect the funds of the corporation for the payment of interest on the debentures and for working capital purposes. The dividend restrictions take various forms, several of which are illustrated in the indenture of the Celanese Corporation of America 3 per cent debentures due in 1965. The corporation cannot pay cash dividends on common stock[14] unless thereafter the earned surplus is equal to $10,000,000, current assets are two and one-half times greater than current liabilities, and net current assets equal at least $25,000,000. The corporation cannot pay dividends on any class of stock unless net tangible assets thereafter are two and one-quarter times the funded debt.

Other provisions in the trust indenture may require that working capital be maintained at a certain level, or may impose restrictions on the sale and leaseback (see page 435) of major properties.

[14] The payment of stock dividends is permitted since it does not affect current assets. It results in a reduction of surplus and hence reduces the book value per share of the outstanding common stock. See pages 404 et seq.

Other Secured and Unsecured Bonds

Guaranteed bonds. Bonds that are guaranteed in regard to principal, interest, or both by a corporation other than the issuing company are called guaranteed bonds. Such bonds have the security of the mortgage on the property of the issuing corporation, if they are mortgage bonds, the protection of the general credit of the issuer, and in addition, the protection of the credit of the guarantor. If they are unsecured bonds, they have the credit of the issuing company and of the guaranteeing company behind them. Guaranteed bonds frequently become known in investment circles by the name of the guaranteeing company. They will usually sell in the market as though they were a security of the guarantor, and the market price may bear little or no relation to the fortunes of the issuing corporation. The contract of guarantee is frequently stamped or endorsed on the face or reverse side of the bond, in which case the bond will be called *stamped* or *endorsed*.

Guaranteed bonds originate usually in the following ways:

1. *Financing subsidiary*. A parent company may find it expedient to have a subsidiary acquire property with the proceeds of its own bonds.[15] Since the issue is likely to be small and the subsidiary little known, these bonds will lack the essential investment element of marketability and will therefore have to yield a high rate of interest. If, now, the subsidiary has to pay dearly for its capital, the parent company will suffer, since little will be left from the earnings with which to pay dividends on the subsidiary's stock held by the parent company. To meet this difficulty the parent may guarantee the interest on the bonds of the subsidiary, or the interest and the principal, and thus secure more favorable terms on the bond issue.

2. *Merger, consolidation, or reorganization*. A corporation that has issued non-callable bonds may become one of the parties to a merger or consolidation agreement. To satisfy the bondholders, it may be necessary for the corporation that takes over the properties of the issuing corporation to guarantee the interest and principal of the outstanding bonds. Without such a guarantee it may not be possible to carry out the merger, consolidation, or reorganization. Actually, the guarantee adds nothing if the issuing corporation goes out of existence through the merger beçause a consolidated company assumes the debts of its constituents and specific liens are not disturbed.

3. *Leasing, royalty and other agreements*. The legal obligations of a lessee under a leasing agreement often include a guarantee of the

[15] Another method of financing subsidiaries was referred to at page 126. The general subject of financing subsidiaries will be discussed more fully in Chapter 25.

interest payments and principal of outstanding bonds of the lessor corporation. For example, under the terms of a lease between the New York Central R.R., lessee, and the Cleveland, Cincinnati, Chicago & St. Louis Ry. Co., New York Central agrees to pay, as part of the rental, principal and interest on the C.C.C. & St. L., St. Louis Division first collateral 4's due 1990. Certain royalty and price agreements operate with the same result.

Equipment trust bonds, financed under lease arrangements as explained at page 128, are guaranteed as to principal and interest by the lessee railroad.

Joint bonds. Joint bonds are guaranteed bonds that are backed by two or more guarantors. They arise principally in railroad financing. The corporation that has title to a railroad terminal property, for example, issues bonds secured by a mortgage on the terminal property. The property, however, in event of default, would be valuable only to the railroads that use it and not to any foreclosing bondholders. Therefore, the corporation owning the station issues bonds secured by a mortgage and guaranteed jointly and severally by all of the railroads that run tracks into the station. Twelve lines guarantee the Kansas City Terminal 4's due 1960. Throughout the history of the issue, at least three roads have been in a financial position to make good their guarantees. At times, these Terminal bonds have sold well above the senior issues of the guaranteeing lines.

Assumed bonds. Assumed bonds are bond issues that some corporation other than the issuing corporation has agreed to take over as its obligation. They differ from guaranteed bonds in that for guaranteed bonds the obligation continues to be that of the issuing corporation; the guarantor merely pays the interest and principal if the issuing corporation fails to do so. Because the original issuer of assumed bonds frequently goes out of existence, there are not always two companies to which the bondholders may look for payment of interest or principal as in the case of guaranteed bonds. Nevertheless, the holders of assumed bonds are in a strategic position. They have a claim against the assets covered by the indenture under which the bonds were issued, plus a general claim against the corporation that assumes the obligation; and if the issuing corporation is still in existence, the bondholders have a claim against it as well.

It does not necessarily follow, however, that bonds are stronger because they have been assumed. Assumed bonds arise usually through consolidation or merger, reorganization, and dissolution of minor subsidiaries by parent corporations. The fortunes of the company that assumed the obligation, the use it has made of the properties acquired from the company whose bonds were assumed, and other conditions,

may add to or detract from the investment quality of the assumed bond.

In all fields of enterprise there are instances of assumed bonds. When Kaiser-Fraser Co. bought the assets of the Graham-Paige Co. in 1947, it assumed the obligation for both principal and interest on the Graham-Paige debenture 4's due 1956. Assumed bonds are especially common in railroad finance because the history of American railroads includes periods of growth and development through acquisition, merger, and consolidation, and periods of financial difficulties and reorganization. The assumed bonds of the railroads have had various fortunes; some have been retired, some refunded, and some assimilated into general mortgages. Some were assumed successively by different corporations as merger followed upon merger.

Receiver's certificates. Companies that go into receivership are faced with the problem of securing funds to meet current operating expenses. Since investors will not purchase new securities of an embarrassed corporation, to meet this problem the court appointing the receiver may direct him to raise money by selling receiver's certificates. These certificates are usually short-term obligations of the receiver, which will be paid off from the assets of the company in receivership. They will have a lien on the property of the company in receivership wherever the court places it; frequently their lien comes prior to those of some or all of the older mortgages. Usually, the reorganization will provide for the raising of sufficient cash to liquidate these securities. At any rate, the court will not discharge a receiver until it is satisfied that equitable arrangements have been made for meeting the payment of the receiver's certificates. Ordinarily the purchasers of the receiver's certificates come out of the reorganization without loss on their investment.

Income and adjustment bonds. An income bond is a bond the interest on which is to be paid only when the company earns it. Some income bonds have no lien on specific property; others have a junior mortgage claim; and some have senior liens. Income bonds in the past were rarely issued for public subscription; they resulted primarily from reorganizations. Hence, the name *adjustment* is frequently found in combination with the word *income* or in place of it. Recently, however, income bonds have been issued with increasing frequency by solvent companies, primarily for the purpose of eliminating preferred stock.

The first large issue of income bonds by a solvent corporation for the purpose of preferred stock redemption was the Western Pacific Railroad's $22,500,000 issue in September 1954. Since that time other solvent corporations have issued income bonds to eliminate or reduce

the outstanding preferred stock through exchange for income bonds or through redemption with the proceeds of the sale of the income bonds.[16]

Income bonds are also sometimes issued in connection with mergers (Chapter 23). They may be offered to the stockholders of the company being absorbed in exchange for their common or preferred stock. If offered in exchange for common stock, they prevent dilution of voting control of the merging corporation. If offered in exchange for preferred stock, income bonds prevent undue financial burdens that might cause trouble during the period immediately following the merger. Thus, in the merger of Consolidated Film Industries, Inc. with Republic Pictures Corporation, income bonds were included in the securities exchanged for the preferred stock and unpaid dividends of Consolidated Film Industries.

In reorganizations, the purpose of income bonds is twofold: (1) to offer the bondholders of the company a creditorship type of security in exchange for bonds that have defaulted; (2) to enable the reorganized company to lighten its financial burden when the need for relief is urgent.

The payment of a return on income bonds often depends upon the fairness of the directors, since some indentures give the directors wide latitude in defining net income.[17] Other indentures state specifically what constitutes net income and how it is to be applied before income is paid to income bondholders. Under a reorganization plan approved by the Interstate Commerce Commission, which became effective in 1947, the New York, New Haven and Hartford Railroad issued 4½ per cent income bonds due in 2022. The indenture enumerates a long list of payments that must be made out of net income before any income may be considered available for the holders of the income bonds.

To make the income bonds more acceptable to the bondholders, and to give the investors some hope of eventually sharing in future earnings, corporations have found it necessary to add "premium" features. Thus, many income bonds are cumulative and convertible into stock. When the bonds are cumulative, arrearages of interest must be met before dividends can be paid on stock. The cumulative feature is obviously adapted from cumulative preferred stock with which this

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[16] For a full discussion of income bonds, particularly with respect to their use in situations other than reorganization, see Sidney M. Robbins, "A Bigger Role for Income Bonds," *Harvard Business Review,* November–December 1955, p. 100.

[17] Difficult questions of accounting may arise in calculating income available for these bonds, and since the margin of income above interest requirements is small, the importance of deciding those questions one way or the other has often led to vexatious litigation.

type of bond is often compared.[18] In some instances, the cumulative provision does not take effect until some years, usually five, after the bonds are issued, to give the corporation time to regain its financial health. At other times, the bond indenture provides that income payments in arrears can accumulate only for a certain number of years or to a maximum percentage. The New York, New Haven and Hartford income bonds mentioned above provide that income shall be cumulative up to 13½ per cent and no more. The same issue gives the income bondholders the privilege of converting $1,000 face value of bonds at any time into ten shares of preferred stock.

Because of the uncertainty of their income, income bonds are generally not looked upon with great favor by investors. However, some income bonds can show a record of consistent payments. The Atchison, Topeka and Santa Fe Railroad Adjustment 4's, which were due and were paid in 1955, are an example of such bonds with an exceptionally good record. The bonds grew out of the reorganization of the railroad in 1895, and paid continuously until 1938 when there was a default on one semi-annual payment. The company then met all payments until the bonds were retired. The Gulf, Mobile & Ohio Railroad Company general mortgage income 5's, Series A, due 2015, also have an exceptional record. These bonds grew out of reorganization of the railroad in 1939. Interest is to be paid out of available net income up to 5 per cent per year. The first payment, made in 1941, amounted to 2½ per cent. Since that time, the railroad has paid 5 per cent each year.

Split-coupon bonds. A split-coupon bond is one that carries a fixed rate of interest and, in addition, interest contingent on earnings. Like the income bond, it has been issued as a result of corporate reorganization or debt readjustments, particularly in the fields of real estate and railroad finance during the forties. For example, the Baltimore & Ohio Railroad had outstanding (called in April, 1956) $66,000,000 of first mortgage 4–5's. The numbers mean that 4 per cent interest is fixed and 1 per cent is contingent on earnings. It was observed through comparison of market prices of split-coupon bonds with comparable income bonds, while earnings were good, that investors tended to disregard the contingent rate. This development will tend to discourage the use of split-coupon bonds.

Participating bonds. In very rare cases corporations have issued participating bonds. Whereas the holders of income bonds may receive

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[18] Actually, railroads have issued income bonds instead of preferred stocks because of restrictions of some states that would prevent insurance companies from holding preferred stock in place of their defaulted bonds. In this case, the issuance of preferred stock would needlessly complicate the adjustment of creditors' claims.

less interest than a stipulated maximum, holders of some participating bonds may receive more than a stipulated minimum, depending upon the earnings of the company and the terms of the contract. During 1927 and 1928 several toll bridge companies issued participating debenture bonds. The first sinking fund gold debenture 6½'s of the San Francisco Bay Toll Bridge Co. had coupons attached to them entitling holders to participation on interest dates in semi-annual net earnings, after certain specific deductions, to the extent of 1½ per cent of the principal amount of debentures outstanding.[19]

One of the few examples of such bonds in existence today that has maintained a consistent record of payment are the Green Bay and Western R.R. Class A income debentures. They were issued in 1896 and are due only when the company is sold or is reorganized. Interest is payable, if earned, up to 5 per cent. Net income after taxes and certain other charges is divided equally with the common stock up to 5 per cent, the bondholders and stockholders each getting 2½ per cent. Then, if there is any additional net income, they share again until each has received a maximum return of 5 per cent. Interest payments are protected in part by the indenture provision that company property cannot be mortgaged without the consent of 75 per cent of the holders of the stock.

Miscellaneous bonds. To round out the discussion of corporate bonds, a brief explanation will be given of bonds issued with stock purchase warrants, and extended bonds. These bonds may fit into any of the categories previously discussed.

Bonds issued with stock purchase warrants. Like participating bonds, this type of bond represents an attempt to sweeten securities that are not particularly attractive to investors. Also, like participating bonds, the bond with stock purchase warrants attached to it presents the bondholder with the possibility of sharing in common stock profits while holding on to his bond.

Stock issues, as well as issues with stock purchase warrants attached, appeared in great number, especially during 1929. The tendency to make bonds more attractive by according the purchaser rights to acquire common stock was followed to some degree in financing during the thirties. In the forties, some small bond issues with stock purchase warrants were issued by industrial companies.

The nature of stock purchase warrants is the same whether they are issued in connection with an issue of stock or an issue of bonds. The explanation at pages 94 et seq. should therefore be consulted.

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[19] Under the reorganization plan adopted in 1941, the holders of these bonds received $1,000 new income bonds and two shares of new common for each $1,000 bond held.

Extended bonds. Extended bonds are matured bonds which, by agreement between the bondholders and the corporation, have their maturity date extended for a number of years. In extending the bonds it is not unusual to change the interest rate, raising it or reducing it to meet the particular circumstances. Also, if the bonds have such features as the conversion privilege, or were issued with stock purchase warrants, these special features are frequently allowed to lapse when the bonds are extended. Extension agreements are commonly arranged when the corporation is unable to pay the bonds at maturity, or to raise new funds with which to refund the maturing issue, and when the extension will better serve the interests of the bondholders than foreclosure and sale of the property.

Research Question

From your daily paper, Moody's, or any other source, list four secured bonds and four unsecured bonds. Do the companies having the unsecured bonds have any secured bonds outstanding?

Problem

The Clear-Vue Television and Radio Corporation has received government orders for radar and radio parts. It needs to increase its production facilities, however, to continue civilian production. Its cash position is strong, its current assets are four times greater than its current liabilities, and it has no mortgage on its plant. Which of the following bonds might be sold?

1. Mortgage bonds.
2. Collateral trust bonds.
3. Income debentures.

Justify your answer.

CHAPTER 8

Extinction of Bonded Indebtedness

Methods of extinguishing bonded indebtedness. Since bonds are debts, and since all debts must be liquidated sooner or later, we must study what plans a company can and does make for wiping out the obligation of a bond issue. Bonded indebtedness may be partially or wholly extinguished by redemption, refunding, or conversion.

Redemption means the exchange of bonds for cash.

Refunding means the exchange of bonds for other bonds whose maturity is deferred to a date later than that of the original issue.

Conversion means the exchange of bonds for certain other forms of security, usually stock.

Any of these methods may take place at maturity or before maturity, if the contract so provides. Of course, subsequent to the issue of the securities—that is, after the contract is first entered into—the parties may change the contract by mutual consent. Thus, some of the processes take place before maturity, not in pursuance of the original contract, but as the result of subsequent negotiations or supplementary agreements.

Each of the methods of extinguishing bonded indebtedness will be discussed in this chapter. Immediately following them, *sinking funds* will be explained since their main purpose is to assure redemption of all or a portion of outstanding bonds before or at maturity.

Redemption

When redemption takes place. Redemption, that is, the exchange of bonds for cash, may take place (1) at maturity of the bonds, as provided in the contract covering the bonds, or (2) at the option of the issuing corporation, before maturity but under the terms of the contract, or (3) before maturity and not under the contract, but as a result of a subsequent agreement.

Where the trust deed under which the bonds were issued gives the company the option to redeem before maturity, the redemption may be called "mandatory." Redemption by subsequent agreement may be termed "solicited."

Redemption at maturity. Redemption at maturity consists of the corporation's depositing with the trustee the funds required to meet the obligation. The bondholder turns his bond over to the trustee and receives in return a check in payment of the principal of the bond, plus the interest for the last interest-payment period.

Redemption before maturity under a call provision. Before we mention the reasons that prompt a company to rid itself of the obligation of an issue or part of an issue through redemption before maturity, let us see what the provisions of the mortgage or deed of trust giving the company the right to redeem consists of. The principal parts of the provision are: (1) time of redemption; (2) redemption price; (3) amount to be redeemed; (4) notice.

Time of redemption. Usually, the company must redeem at an interest date or at some other fixed time. The purpose of this provision is to give the bondholder an opportunity to inquire, without constant worry, into the status of his holdings.

The company may not be permitted to call the bonds for redemption for a specified period of time after their issue. This restriction tends to make the bonds more attractive to the investor, who does not want to invest large sums in bonds that may be called for redemption in a very short time. Thus, the American Telephone and Telegraph Company 5 per cent debentures, due 1985, were issued November 1, 1957, with the provision that they were not callable until November 1, 1962.

Redemption price. The price at which the bond is to be redeemed is stipulated. This may be par, although usually a premium is provided for. The premium frequently is graduated, with bonds called first receiving the highest premium. For example, the AT&T debentures due 1985, mentioned above, are callable at 106.461 between November 1, 1962, and November 1, 1963. After that the redemption price decreases annually to 100.

Amount to be redeemed. Frequently, the issue is retirable only as a whole; sometimes less than all the bonds, but not less than a certain specified amount, may be redeemed at one time. For sinking fund purposes, as we shall see (page 154), the company may retire each year enough bonds to use up its sinking fund payment. Where less than all of an issue of bonds is to be redeemed at one time, it is usual to provide that the numbers of the bonds to be redeemed shall be determined by lot.

If serial bonds (see page 110) are redeemable, the provision for

redemption frequently includes a clause for the calling of bonds in the reverse order of their maturity. Thus the issue may provide that the last maturing bonds are to be called first, at par plus a premium of ⅕ of 1 per cent for each year of the unexpired term. The bonds redeemed longest before maturity thus receive the highest premium. From the standpoint of the bondholder, this arrangement, despite the premium, would seem objectionable, since one who has selected a later maturing bond evidently wished a longer term investment, whereas one who selected an early maturing bond wanted to get his money back quickly. The company follows the practice, of course, in order to accelerate cancellation of the entire indebtedness and to retire first the last maturing bonds of the series because they carry the highest rate of interest.

Notice. Notice of redemption is generally required. The notice usually is given about sixty days before the redemption date, although it may run as long as ninety days or may be as short as two weeks. In the case of registered bonds, the notice is sent to the bondholder at his last known address. In any event, the clause generally provides for publication in designated newspapers.

Technique of payment of called bonds. The money for redemption of called bonds is usually deposited with the trustee as in the case of redemption at maturity. If the bonds are properly redeemed under a mandatory provision in the indenture, interest ceases to run from the redemption date. Since the trustee holds the money *for* the bondholders and not *adversely,* the statute of limitations will not run on the debt if the bondholders fail to make application for their money.[1] For this reason many indentures provide that after a certain number of years the money, if unclaimed by the bondholder whose bond has been called, shall be returned to the company. In such event the debt would probably be outlawed in twenty years in most jurisdictions.

Redemption before maturity of non-callable bonds. In the redemption of bonds before maturity, the agreement to give up the bond for cash may simply amount to a purchase of the bond by the company through the stock exchange or through an investment house; or it may be the result of negotiations made directly between the company and its bondholders. The distinction between these two methods lies in the fact that where the bond is bought through a broker or investment house, the bondholder is not apprised that his bond is being bought by the company for redemption, whereas in the case of negotiation he knows that the company has funds to dispose of.

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[1] Usually a debt is outlawed in six years, or, if owing on a sealed instrument, in twenty years But where the money for redemption is turned over by the company to the trustee, it is no longer "owing," since, as indicated in the text, the trustee holds in behalf of the debtor and not in behalf of the creditor.

Purposes of redemption before maturity. A number of reasons may prompt a company to redeem all or part of an issue before maturity. These reasons are important enough to demand separate though brief consideration.

1. *Redemption as a means of reducing fixed charges.* The income of some forms of industry is so unstable that the burden of a fixed charge is a constant menace. Whenever bonds have been sold in periods of need, the first opportunity is seized, after prosperity has endured long enough to build up profits, to pay off the bonds. A corporation may even find it expedient, in periods when cheap money is available, to borrow from banks for short terms and use the proceeds to redeem its bonds. The bank loans are paid off from future profits or through later new permanent financing that carries lower interest rates than the redeemed bonds.

2. *Redemption as a means of avoiding onerous terms.* Bond issues that were made at a time when later developments could not have been foreseen are likely to contain terms that are extremely disadvantageous to the corporation or to its stockholders. For example, there may be burdensome restrictions on the right of the corporation to increase its indebtedness, or on the right to pay dividends.

3. *Redemption as a step in refinancing.* Redemption is frequently the first step in a refinancing plan to strengthen the corporate structure. For example, if a company has a small underlying issue that might interfere with the sale of a large issue of subordinate bonds, the underlying bonds may be redeemed to clear the property and thus prepare it for the lien of the larger issue.[2]

4. *Redemption as a means of investing cash.* A company will often have surplus cash on hand shortly before the maturity date. Instead of investing this cash, paying the commission for purchase of the investment securities and again for their resale when the cash is needed at the maturity of the company's own bonds, in the meantime standing the risk of loss—the company must sell the investments in time to use the cash, however the investment market stands at the time—the cash is used to redeem the bonds before maturity. This procedure may be followed even though it is necessary to pay a premium to assure the retirement of the bonds. However, money may be lost by paying a premium when, by waiting a year or so, the premium might be avoided.

5. *Redemption as a credit tonic.* A debt is an incentive to work to make ample provision for the interest payments. The mere fact that there is a responsibility to bondholders may keep up the tone of the administration. However, people do think of debts with abhorrence.

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[2] This process has been described on page 124.

They picture in their mind's eye the burning of the church mortgage. Thus, corporations announce with pride that "with this payment, the company will be entirely free from debt."

Disadvantages of redeemable bonds to the bondholder. Interest ceases from the redemption date, as was previously indicated. The bond is likely to be redeemed by the corporation at a time when money is plentiful and interest rates are low. The bondholder who purchased at a time when interest rates were high would be in an advantageous position if he could keep his bond during a period of declining interest rates. This advantage is frequently lost by redemption. The greatest difficulty for the investor is the expense of reinvesting the funds, as well as the risk involved in finding a new security that will pay fair income and still be reasonably safe. To offset these disadvantages, the redemption premium is provided. Just how large the premium shall be is a matter to be determined by the company in providing a contract that it thinks will attract investors. If any rule can be laid down, perhaps it is that the premium should amount to one year's interest. This would compensate the bondholder for a possible loss of interest through neglect to claim his money when the bonds are called and would also give the bondholder one year to look around and find a good investment.

Refunding

When refunding takes place. Refunding is a substitution of one kind of security for another—the exchange is bond for bond. Refunding may take place (1) at or near the maturity of an old issue, to meet the maturing obligation, or (2) before maturity.

Refunding at maturity. In refunding at maturity, the corporation arranges to pay off the maturing bonds with the proceeds of a new bond issue that is sold to a group of bankers for distribution to the public, or to one or more insurance companies or other large institutional investors to be held by them. Occasionally, in a refunding at maturity there is a direct exchange of bonds. The existing bondholders are offered the new bonds in exchange for their old bonds, or cash if they do not desire the new bonds.

Reasons for refunding at maturity. Refunding at maturity of an issue may be done either because the company believes it is good policy to continue its borrowing, or because the company cannot get the cash funds with which to pay off the maturing obligations.

When a company's loan matures, the first question the directors ask is, "Can the business use the funds profitably for a longer period?" Generally, if it pays to borrow, it pays to continue to borrow. Suppose an obligation of $1,000,000 matures, and that the company could draw the $1,000,000 out of the business to pay off the loan. The di-

rectors must first ask, "Can not the corporation with safety earn much more on that $1,000,000 than it is paying on the loan?" If so, the loan should be refunded. To be sure, the business may be very hazardous and it may be the part of wisdom to be rid of the fixed obligation of interest. Each case must be taken as a separate problem in settling that question.

The kind of business in which the corporation is engaged has a bearing upon whether its bonds will be refunded at maturity, as a matter of policy. Companies with unstable earnings, industrials, for example, generally seek to pay off their bonded indebtedness, or at least to reduce it. Public utilities, on the other hand, which have greater stability of earnings, follow the policy of carrying a perpetual debt. Also, they as well as the railroads find it necessary to finance with borrowed capital because of the large investment in fixed assets that is constantly required to keep operations running smoothly. Refunding, therefore, is usually necessary financial policy in these fields.

Refunding before maturity. Refunding before maturity may be accomplished in two ways. (1) If the bonds are callable, the company exercises its option to redeem the old bonds. The situation then is the same as in the case of refunding at maturity. Usually, the entire new issue is sold to investment bankers and the proceeds of the sale are used to redeem the called bonds. (2) The bonds may be refunded through negotiation, in which case the company must rely on the voluntary consent of the old bondholders.

Corporations usually engage bankers to insure or underwrite the refunding operation where voluntary consent of the existing bondholders is required. The company generally announces the terms of the refunding and the bankers add a statement of their readiness to pay cash if the bondholder desires cash instead of the new bond. The mere fact that the bondholder can have the cash if he wants it is one good reason why he will accept the new security. The banker furnishes the cash needed to pay off the bondholders who do not want to exchange their bonds for those of the new issue. The bankers are reimbursed by taking the refunding bonds offered the old bondholders and selling them to other investors.[3]

Reasons for refunding before maturity. The purposes of refunding a bond issue before maturity date are:

1. To reduce the fixed charges of an issue that has still some time to run; in other words, to take advantage of favorable market condi-

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[3] If the new bonds cannot be validly issued until the old bonds have been retired, and if the market is not suitable for the sale of a new issue at the time the redemption is to take place, the corporation may obtain funds for paying off the old bondholders by arranging a bank loan, with assurance as to renewal, to carry it until such time as a new issue can be favorably sold.

tions. In each period of low interest rates, corporations have taken advantage of the change in money market conditions to reduce fixed charges on existing debt. Numerous illustrations could be given; just three are cited to show how, in one year, railroads, public utilities, and industrials replaced low-interest bearing securities with still lower-cost issues, to reduce their fixed charges.

Great Northern Ry. Co. issued $40,000,000 general 2¾'s, Series P, due 1982, and $35,000,000, Series Q, due 2010. The proceeds, with other funds, were used to redeem $75,000,000 general mortgage bonds consisting of (1) all $30,000,000 3⅜'s, Series L, due 1970, (2) all $35,000,000 3½'s, Series M, due 1980, and (3) $10,000,000 of $35,000,000 outstanding 3⅛'s, Series K, due 1960.

Missouri Public Service Corporation sold privately $5,100,000 of first 3's, Series A, due 1976. The proceeds were used to redeem first 4's, Series A, due 1967, and 3½'s, Series B, due 1970.

Standard Oil Company of New Jersey issued $85,000,000 debenture 2⅜'s, due 1971, to redeem all $85,000,000 debenture 3's due 1961.

2. To carry out some new financing. One example of refunding for this reason occurs when the corporation wishes to raise additional cash through the sale of bonds secured by property on which other mortgages exist. The company may refund the bonds secured by the underlying mortgages into the new bonds. Another instance of such refunding occurs in refinancing subsidiaries. A company may have guaranteed the bonds of its subsidiaries and have demanded in return the right to redeem the issue, knowing that later it might be advisable to consolidate the companies and to refinance the new company under one large mortgage. When such refinancing takes place, the bonds issued under the one large mortgage bear a relatively low rate of interest, made possible because the new bonds will be well-known as part of a very large issue and will thus have the desirable investment quality of marketability.

Inducements to refund. Inducements must sometimes be offered to cause bondholders to accept refunding issues. Some of these inducements are: (1) a cash bonus; (2) higher rate of interest; (3) partial payment in cash; (4) agreement to create a sinking fund; (5) wider market for the new securities; (6) better security; (7) guaranty by a parent company that has acquired the issuing company as a subsidiary.

Conversion

General nature of conversion privilege. The conversion privilege gives the bondholder the option to exchange his bond for another form of security of the issuing corporation, usually common or preferred stock. The advantages of owning a convertible bond are re-

flected in the popularity of such bonds. When an investor buys a bond convertible into stock he gets (1) the certainty of income characteristic of the bond; (2) the preferred position of a creditor if the company should fail; and (3) the chance of sharing in the profits if the company becomes prosperous, which chance is the peculiar privilege of the stockholder.

So far as the corporation is concerned, the conversion substitutes the contingent charge of dividends for the fixed charge of interest, and thus reduces fixed charges. In practice, this advantage may be more apparent than real, for in getting rid of the fixed charges the company pays higher rates in the form of dividends.[4] Moreover, as the conversion privilege becomes more valuable to the bondholder because the stock is beginning to yield large dividends, the bonds are relatively less troublesome to the company.

Conversion generally takes place before maturity of the bond. It may, however, take place at any time until maturity, although a specified number of days before maturity is often indicated. If the bond is redeemable, as well as convertible, the bondholder usually has the option of converting prior to redemption. This enables the bondholder to take advantage of any premium in market value over the call price.

Why the conversion privilege is given. A corporation will include the conversion privilege in its bonds for the following reasons:

1. *To reduce the cost of financing.* The underwriting costs are lower when the company issues convertible bonds than they would be if the company issued common stock or straight bonds. The reason for the lower underwriting costs lies in the attractiveness of the bonds to the investor. Because of their attractiveness, the convertible bonds are easier to sell.

More important than the lower underwriting costs is the reduction in the rate of interest that is possible with convertible bonds. Convertible bonds may bear a lower interest rate than straight bonds, since the investor is willing to forego interest for the conversion privilege.

2. *To make the bonds more attractive.* We have already explained above why convertible bonds are popular. The addition of the conversion feature to help the sale of the securities applies particularly when stocks are in public favor. During periods when common stocks have risen in value, bond buyers have demanded a security that affords safety combined with a possibility of profit through conversion into common stock. If a new bond issue lacks high investment merit, the

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[4] Out of a total issue of $49,711,000 of the Atchison, Topeka & Santa Fe Ry. Co. 4's of 1955, Series A, $42,926,000 was converted into stock. In years when the company was paying 10 per cent on its stock, the conversion was costing the company 6 per cent on $42,926,000, or about $2,575,560 a year—a sum, if set aside annually, more than sufficient to retire the bonds at maturity.

conversion feature may be added to attract buyers. For example, if a company has exhausted the earlier liens on its properties, it may give the conversion privilege as a substitute for a good lien. Thus, most railroad convertibles are secured by junior mortgages, or are debenture issues.

3. *To facilitate the extinction of the debt by the substitution of stock for bonds through conversion.* In many instances, market conditions do not permit the sale of stock. The corporation therefore issues convertible bonds with the intention of ultimately having outstanding in place of the bonds, after conversion has taken place, the stock it would have sold in the first place had market conditions been favorable for this type of security.

The conversion privilege is also offered to facilitate the extinction of the debt when fixed charges constitute a hazard because of instability or uncertainty of earnings. Many of the convertible bond issues of industrial companies, which ordinarily do not issue long-term bonds, may be regarded as a temporary security, the final security being the stock into which the bond is convertible.[5]

The terms of conversion. The conversion contract is contained in the trust indenture. There the following important provisions concerning the conversion privilege are covered: (1) the kind of security for which the bond is exchangeable; (2) the conversion rate; (3) the period during which the conversion may be made; and (4) the protection offered against dilution of the conversion privilege.

Conversion security. The conversion clause mentions by name the specific security for which the bond is exchangeable. Usually, bonds are convertible into preferred stock or common stock, but most commonly into common stock because the latter has more speculative appeal. The preferred stock into which a bond is convertible must pay a higher rate of dividends than the interest on the bonds; otherwise, the conversion privilege would have no attraction. Thus, the Erie Railroad Co. general mortgage income 4½'s, due 2015, are convertible into 5 per cent preferred stock series B, $100 par value, at the rate of one share of preferred for each $100 of bonds. In some instances short-term notes are made convertible into long-term bonds. This occurs when the company prefers to finance through the issuance

[5] Convertible bonds may also serve to prevent immediate dilution of stockholder interests, while broadening the stockholder base. Through conversion, the number of stockholders will most likely be increased, thereby broadening the base of ownership. The broadening of the stockholder base is considered by many to be desirable. On the other hand, those who own controlling or large blocks of stock at the time of the issuance of the new securities are interested in preventing dilution of their interests. Such stockholders are better satisfied with an issue of convertible bonds, which are converted into common stock gradually, than with an issue of common stock, which might dilute their interests immediately. See Alan Abelson, "New Look in Convertibles," *Barron's,* May 7, 1956, p. 5.

of long-term bonds, but, because of unfavorable market conditions, is compelled to raise funds through a short-term obligation. When actual conversion takes place the company finally has outstanding a long-term bond issue.

Conversion rate. The conversion rate is stated in terms of an exchange of one bond for shares at a certain price, or of one bond for a certain number of shares of stock. At one time the most usual conversion contract was par for par; that is, the privilege was given of exchanging a $1,000 bond for ten shares of stock with a par value of $100. Sometimes, however, the stock was to be taken at either more or less than par. With the increase in the use of no-par stock, it became customary to permit the conversion into preferred or common shares at a certain price per share.[6]

Sometimes a sliding scale is provided, with the conversion price increasing with the passing of time. For example, Daitch Crystal Dairies, Inc., convertible subordinated debenture 4.50's, due 1975, are convertible into common stock on or before December 1, 1975, at the following prices per share of common to December 1 of the year indicated: 1960, $21; 1965, $23.50; 1970, $26; 1975, $28.50. The purpose of this arrangement is to have the conversion rate keep pace with the expected increase in the value of the stock into which the bond is convertible, and also to hasten the conversion process.

Another way to achieve this same result is to base the change in the conversion price on the number of debentures that have previously been converted. For example, Texas Industries, Inc., subordinated debenture 4.60's, due 1975, are convertible into common stock on or before June 1, 1965, at $14 per share until $1,500,000 debentures have been converted, then at $16 until $3,000,000 have been converted, and then at $18 per share thereafter until June 1, 1965, inclusive.

If the stock into which the security is convertible has par value, the law requires that the conversion privilege must be at a rate which will be equivalent to the payment of the par value of the shares which are to be received upon conversion. If the stock is without par value, the conversion rate must have a fair relation to the actual values at the time of the creation of the conversion privilege. Legal difficulties aside,

[6] The American Telephone and Telegraph Company in 1955 departed from the usual conversion rate provisions in its offering of convertible debenture 3⅞'s due October 13, 1967. These bonds are not convertible at a certain price per share of common stock or at so many shares for each bond. Each of these $1,000 bonds is convertible into ten shares of common stock, but only upon the payment of an additional $480. The additional amount that must be paid for conversion makes it possible for the company to raise almost one billion dollars through conversion of the issue instead of only the $650 million involved in the bond issue. See Ira U. Cobleigh, "Open Season for Convertibles," *The Commercial and Financial Chronicle,* September 1, 1955, p. 4.

it would seem advisable to make bonds convertible into stock at a price materially above the price at which the stock is selling at the time the bonds are issued, whether it be stock with or without par value. If there were not considerable margin between the conversion rate and the market price of the stock into which the bonds are convertible, any small increase in the price of the stock would make the conversion attractive. The corporation might then find that conversion is taking place more rapidly than is desirable. On the other hand, if the company prefers to have common stock rather than bonds outstanding, it may well make the bonds convertible into stock at the price at which the stock is selling at the time the bonds are issued, and thus encourage immediate conversion.

Conversion period. The conversion privilege may be limited in time both as to when it begins and when it ends. It is important for the investor to know when the conversion period ends and to watch the relationship of the price of the bonds to the price of the stock in order to take advantage of the value of the conversion privilege, if it has value, before the privilege expires. For example, suppose a $1,000 bond is convertible into twenty-five shares of common stock and at about the time that the conversion privilege is due to expire, the common stock is selling at 56 and the bonds at 141. The price of the bond directly reflects the value of the conversion privilege in this price relationship. The day after the privilege expires, the bonds will fall to the value of the bonds without the conversion right and those who have not converted will have lost a substantial profit. If, in this situation, the security holder prefers to have his funds invested in bonds rather than stock, he can convert the bonds, sell the stock received in exchange, buy back the bond as soon as the conversion privilege expires, or one equivalent to it, and have the profit to boot.

Protection against dilution of conversion privilege. In the explanation of convertible stock given in Chapter 5, the manner in which the conversion privilege may be diluted, changed, or destroyed was indicated. The information given on page 83 applies in all respects to convertible bonds as well as to convertible stock. The adjustment provisions that protect the security holder against dilution of the conversion privilege, explained at pages 83–84, are usually found in trust deeds creating issues of convertible bonds.

Other provisions of convertible issues. Indentures securing convertible bonds contain many other peculiar provisions incidental to the privilege of conversion. The company agrees to maintain a sufficient amount of unissued authorized stock to carry out the conversion. Provision is made to adjust interest and dividends when bonds are offered for conversion, or the contract states that the conversion is to be made without interest or dividend adjustment. The usual arrange-

ment is to allow the bondholder the accrued interest on his bond, but to charge him the accrued dividends on the stock at the regular dividend rate. Sometimes the conversion can only be made on interest dates. Since one of the purposes of conversion is to extinguish the indebtedness, the indenture usually provides for the cancellation of the converted bonds.[7]

Price relationship between convertible bond and stock. To understand the price relationship between convertible bonds and the stock into which the bond is convertible, it is well to distinguish at the outset between investment value and conversion value. The price of a convertible bond always reflects the investment merits of the bond. In other words, the bond has an investment value, determined by the income it pays and the security of the principal. It may also have a conversion value if the stock into which the bond is convertible has gone up in price. Frequently, we find convertible bonds selling at one time on a basis that reflects the investment position of the bond—considering security and income—and later selling at a much higher price, simply because they tend to follow, on the market, the stock into which they are convertible. This upward movement will always take place when the company enters a period of prosperity and is able to pay high dividends. If the company reduces its dividends, the stock and bonds will recede in price, the stock to a price low enough to conform to the reduced dividend rate, but the bonds to a level established by the investment position of the issue without regard to the conversion privilege.

Use of convertible bonds by speculators. Convertible bonds have a peculiar interest for stock market speculators. A speculator in the higher income-tax brackets, who is interested in capital appreciation rather than income, could borrow on his convertible bond to make a large percentage of appreciation on his investment. Assume that such a person buys a National Can 5 per cent convertible debenture due 1976, at 105. He pays $1,050 for the bond and, with the bond as collateral, borrows $1,000 at a rate of interest close to the interest on the bond. If the debenture goes to 110, he has a profit of $50 on a net investment of $50, or a 100 per cent gain. In the case of a National Can bond, which is convertible into slightly more than seven shares of common stock, such a gain might develop from only a slight rise in the stock.

Disadvantages of convertible bonds. Since the conversion of bonds into stock is usually accompanied by an actual offer of the stock on

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[7] The mortgage securing the General Consolidated Mortgage 4's, 4½'s and 5's of 2003 of the Lehigh Valley R. R. Co. provides that the directors may under that mortgage issue convertible bonds and that any of such bonds converted into stock may be reissued.

the market, convertible bonds may be said to have the effect of injuring, though indeed very slightly, the investment position of the company's stock. Were this depression noticeable, the disadvantage would be serious, since it is always important that a company's stock sell well above par.

Another disadvantage of conversion may be apparent when it is considered what the purpose of a corporation is. Aside from the social benefits it renders in producing goods or services, it is managed for the profit of its owners, the stockholders. During the hard periods of corporate infancy, these people "hold the bag"—they get nothing but prospects. In the meantime the holders of convertible bonds are drawing their interest and are also possessors of the prospects of larger returns. When the corporate income increases, the bonds are converted, thus reducing the rate of return that can be paid on the original stock.

Moreover, it should be noted that conversion injures the market position of bonds that remain unconverted. After a bond issue has been fairly well converted, the remaining bonds of the issue may become so limited that their marketability will be very low; few people will hold them and their value will become problematical.

Finally, the effect of conversion on the tax position of a corporation must be considered. When the bonds are issued, the Federal issuance tax is imposed.[8] At that time the corporation usually will not have in reserve sufficient stock for the conversion and will have to increase its stock for this purpose and pay the state tax thereon. When the conversion is made, the Federal issuance tax will have to be paid. Moreover, when interest on the bonds is paid, the amount needed may be subtracted from the income before the net income is reported for Federal tax purposes. But when the bonds are converted, the dividends paid on the stock are taken out of the profits, on which the company must pay income tax. Usually the state franchise tax is higher, too, where stock replaces bonds.

Sinking Funds for Bond Retirement

Sinking fund bonds. Additional protection for payment of secured or unsecured bonds is frequently given by providing in the indenture that funds shall be set aside out of the earnings of the company, at stated intervals, for the specific purpose of redeeming all or a portion of the bonds before or at maturity. These provisions are called sinking fund provisions and the bonds they protect are known as sinking fund bonds.

Under modern indentures, sinking fund payments are made to the trustee or fiscal agent, as required by the indenture, and used by the

[8] The Federal issuance tax on stock is explained at page 91. The rate on bonds is $.10 for each $100 of face value or fraction thereof. Internal Revenue Code, Sec. 4301.

trustee immediately to retire bonds of the same issue. No actual fund is accumulated year after year to be used eventually for the payment of the bond issue at maturity, although that practice existed in the past, and may still exist under some old indentures. In the following discussion, the modern practice is referred to unless otherwise indicated.

All bond indentures do not provide sinking funds. If a company's earnings are stable and the prospects for future earnings are therefore fairly certain, and if bonded indebtedness is a normal part of its capital structure, a sinking fund may not be necessary, provided, of course, the value of the assets is kept up by proper repairs and replacements. Thus, the older railroad mortgages seldom contain provisions for sinking funds.[9] In the case of industrial companies, on the other hand, funded indebtedness is the exception rather than the rule. Such companies generally do not want to be burdened with permanent indebtedness and the constant fixed charges it entails. They are quite ready to provide for sinking funds as a means of extinguishing the indebtedness gradually. Furthermore, the sinking fund feature has a good psychological effect upon investors, who like the additional protection it affords. This in turn makes the bonds easier to sell. Hence, it is customary to have sinking fund clauses in industrial issues. They are also quite common in public utility bond issues. For companies with wasting assets, such as mining, oil, and timber companies, sinking funds are absolute necessities.[10]

Obligatory, contract, and voluntary sinking funds. Sometimes sinking funds are provided for in an indenture because they are required by statute—usually laws governing railroads or other public utilities. In most cases sinking funds are established in pursuance to an agreement included in the indenture with no statutory compulsion. They are voluntary contract provisions. Occasionally sinking funds are started by corporations voluntarily, even without provision for them in the indenture. The setting aside of such a sinking fund as a voluntary proposition is usually regarded as a sign of strong financial position. Where the sinking fund is entirely gratuitous, however, the company may at any time discontinue it.

As a consideration for some concession, a sinking fund may be promised to bondholders holding bonds under an indenture that makes no provision for a sinking fund. For example, when a company wants to make an issue redeemable, it may provide for the creation of a

[9] Sinking funds were used in early railroad bond financing, but they went out of fashion during the railroad defaults at the end of the nineteenth century. At that time, sinking fund payments were held as an accumulative fund to be used at maturity to redeem the bonds they protected. It was not the practice at that time, as it is today, immediately to redeem an amount of bonds equal to the sinking fund payment.

[10] Where the fund is created to take the place of wasting assets, such as timber, oil, and ores, it is usually and more properly called an amortization fund.

sinking fund for the purchase and cancellation of bonds of that issue.

The terms of the sinking fund provisions, especially those fixing the manner in which the sinking fund payments shall be determined, require careful definition of accounting terms, such as "net earnings," to avoid dispute.

Questions preliminary to arranging the sinking fund. In arranging the sinking fund provisions, the following questions must be considered: (1) Shall retirement through the sinking fund be complete or partial? (2) When shall sinking fund payments begin? (3) What amount shall be paid into the sinking fund periodically? (4) What shall be done with the sinking fund payments? These questions will now be taken up.

Total amount of sinking fund. In most cases the sinking fund is so arranged that only part of the bonded indebtedness will be extinguished by maturity. The Atlanta Gas Light Co. first 3's due 1963, for example, contain a provision for a sinking fund that will be sufficient to retire 40 per cent of the issue by maturity. A reduction of the indebtedness by means of a sinking fund insures the refunding process. There are times, however, when it is planned that all of the indebtedness shall be retired by maturity through operation of the sinking fund.

When shall payments begin? The sinking fund liability is a charge that must be met before the profits of the year can be turned over to the stockholders as dividends. Most indentures require the first sinking fund payment to be made the year following the issuance of the bonds, and annually or semi-annually thereafter. However, if the company is not in a strong enough position to pay these charges immediately, the indenture may provide that payments need not be made till some time in the future. This delay is understandable, for the capital assets into which the proceeds of the bonds are turned will not be immediately productive. A delay of two years is not uncommon. A nine-year delay is provided in the Indiana Power & Light Co. first mortgage sinking fund 3¼'s due 1970.

At what rate shall payments be made? Sinking fund payments are usually made in cash. Under modern trust deeds, the corporation may make its sinking fund payments in whole, or in part, in bonds of the protected issue instead of in cash. The indenture specifies how large each payment shall be. The most common methods found in modern trust indentures are:

1. *Fixed annual amounts paid into the sinking fund.* The simplest form of sinking fund is that which requires a stated amount to be paid into the fund each year and to be used for retirement of an equivalent amount of bonds of the issue it protects. The first 2.65's, Series G, of Inland Steel Co., due 1976, provide for payment sufficient to retire $250,000 annually in the period 1947–1953, and $750,000 annually

in the years 1954–1976. This provision increases the burden upon the corporation in later years when the corporation, presumably, will have the full benefit of the earnings of the assets in which the proceeds of the bonds have been invested.

2. *A fixed percentage of bonds outstanding.* In open-end mortgages, since it is not possible at the time of the drafting of the mortgage to know whether and when all the authorized bonds will be issued, it is customary to set the sinking fund payments as a percentage of the total bonds issued. The Idaho Power Co. first 3½'s, series due 1973, provides for annual sinking fund payments equal to 1 per cent of outstanding bonds.

3. *Sinking funds variable with earnings but with fixed minimum.* Bonds with sinking fund payments that vary for one reason or another, with a fixed minimum, recognize two principles: (1) that the term of the bond is fixed, and that if the indebtedness is to be made up out of earnings during the life of the bond, each year will have to bear some burden; and (2) even if the company has no earnings, the passage of time is bound to tend to reduce by depreciation the value of the equity behind the bonds. Indeed, an abandoned property may and usually does deteriorate more rapidly than a used property, and it is wise, therefore, to require some payment that may induce continuous operation. Continental Diamond Fibre Co. fifteen-year convertible debenture 4's, due 1960, require annual payments of $66,000 plus 10 per cent of consolidated net income for the preceding calendar year.

Variations of this plan include (1) a provision for the payment of the greater of a fixed amount of cash or a percentage of the net earnings; (2) a fixed percentage of the amount of bonds outstanding plus a percentage of the net income for the preceding year; (3) a fixed annual amount plus a percentage of dividends paid on the company's capital stock during the preceding calendar year, and many others.

4. *Sinking funds varying entirely with profits.* Sometimes this arrangement is fairly simple, the provision calling for annual sinking fund payments equal to a certain percentage of the net income for the preceding year. Or, the payments may be fixed at an increasing percentage of the net profits, such as 1 per cent for the first five years of the life of the bond, 2 per cent for the next designated period, and so on.

5. *Sinking funds gradually increasing in size.* A provision to have the sinking fund payments increase gradually in size over the life of the bonds places the heaviest burden on the company's earnings when the company is most able to bear them. The General Telephone Corporation's debenture 4's, issued in 1949, and due 1964, call for delivery to the trustee of debentures in an amount of $400,000 in 1952,

increasing $5,000 annually thereafter, but not at a redemption cost to exceed the corporation's consolidated net income for the preceding year.

6. *Sinking fund installments varying with amount of depletion.* When a bond issue is secured by wasting assets it is natural to regard the sinking fund as the equivalent of the material that has been used up to earn the company's income.[11] It would appear, therefore, that the increase in the sinking fund should bear some relation to the rate of depletion—that is, the rate at which the material is used up. The Hudson Coal Co. first mortgage 5's of 1962 call for an annual payment of (a) a sum equal to five cents per ton of anthracite mined, and (b) an additional amount equal to the difference between (a) and 1 per cent of the principal amount of bonds issued.

7. *Contingent sinking funds.* Provision is made in some indentures for a contingent sinking fund. The Chicago, Milwaukee, St. Paul & Pacific R.R. general mortgage convertible income 4½'s, Series A, due 2019, have a sinking fund contingent upon the payment of dividends on the common stock. A sinking fund payment of 50 per cent of dividends on the common stock is required.

8. *Offsets to sinking fund requirements.* Since outstanding bonds enjoy an improved position whenever the indebtedness that has a prior lien or an equal lien is reduced, such a reduction theoretically is the equivalent of a sinking fund for the junior or co-ordinate issue. For example, if issue "A" for $1,000,000 has a first lien on the property, and issue "B" for $2,000,000 has a second lien, as illustrated in the diagram below, "B" would be as much improved by a reduction of "A" through $250,000 paid out of earnings as it would be by adding to the equity $250,000 out of earnings.

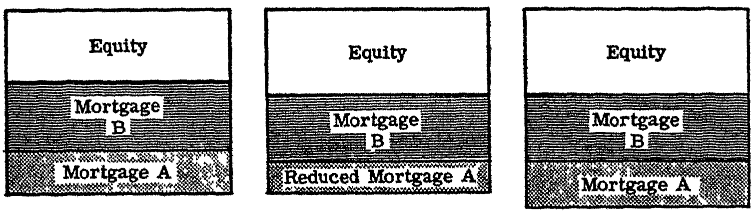

Diagram Showing How Aggregate Equity Is Increased to the Same Extent by Using Sinking Fund to Retire Earlier Mortgage as by Investing Sinking Fund in Additonal Property.

Hence, deeds of trust frequently provide that payments into the sinking funds of prior mortgages are to be deducted from amounts re-

[11] As was pointed out at page 155, sinking funds used for protection against wasting assets are called amortization funds. Sometimes a corporate charter will provide that they shall be used to protect stock as well as bonds.

quired to be paid into the sinking fund of the mortgage in question, until the prior lien is extinguished.

By somewhat the same process of reasoning, sinking funds should be reduced whenever the bonded indebtedness is reduced. If, for example, the sinking fund requirement for "B" bonds in the above example is \$200,000 a year, and if the bonds are convertible and one-half the bonds are converted into stock, the sinking fund ought to be reduced to \$100,000 a year. The Commonwealth Edison debenture 3's due 1999 provide that the annual sinking fund payments are to be proportionately decreased if debentures are retired otherwise than by sinking fund. The Daitch Crystal Dairy convertible debenture 4.50's, due 1975, have a similar provision allowing credit for bonds converted into common stock.

Sometimes sinking fund payments are offset by waiving the right to issue an equal amount of bonds for property acquired. Montana Power Company first 2⅞'s, series due 1975, provide that cash deposited under the sinking fund provisions may be withdrawn on waiver of the right to authenticate bonds against property additions or retirement.

9. *Anticipating and delaying sinking fund payments.* Frequently, when companies that have determined to eliminate bonded indebtedness have years of exceptional prosperity, they anticipate the requirements of their sinking funds by one or more years. The tangible evidence of the company's prosperity that this procedure gives is likely to be reflected in the market standing of its securities. Furthermore, anticipated payments make it easier for the company in years when poor earnings would make the sinking fund payments a hardship.

Some indentures provide that the sinking fund payment need not be made in bad years, but must be accumulated and made up in later years. For example, the Texas & Pacific general and refunding 3⅞'s, Series E, due 1985, stipulate that sinking fund payments must be made only to the extent earned, but are cumulative. Furthermore, this indenture provides that no dividends may be paid on any class of stock while a deficiency exists in the sinking fund payments. On the other hand, the mortgage indenture of the Chicago Great Railway Co. first 4's due 1988 provides that deficiencies in sinking fund payments caused by a lack of available income do not accumulate.

What shall be done with the sinking fund payments? Under modern trust indentures this question is answered simply: Apply the fund immediately to retirement of bonds issued under the indenture. The advantages of this use of sinking fund payments are: (1) The problem of finding a safe investment for the fund at a fair rate of return is eliminated; (2) the sinking fund definitely accomplishes its purpose of extinguishing the debt; (3) the regular investment of the sinking fund payment provides a demand for the bonds on the market and

thus maintains the price; (4) manipulation of the fund is less likely to occur; (5) the credit position of the company is improved as the bonded indebtedness declines; and (6) the bonds remaining are better protected, provided the value of the assets is properly maintained.

One great disadvantage of the investment of the sinking funds in bonds of the same issue is that as the bonds are retired, the market narrows for those bonds that remain outstanding; they thus lose marketability. In the case of some railroad and public utility bonds, provision is made for using the sinking fund to retire bonds secured by a prior mortgage. Thus, the mortgage securing the 3–5's of 1962 of the International Railways Company provides that the sinking fund shall be applied to the extinction of prior lien indebtedness. This provision avoids the possibility of reducing the marketability of the bonds protected by the sinking fund.

Methods of acquiring bonds to be retired. The methods by which the bonds are to be acquired by the trustee who has received a sinking fund payment are usually prescribed in the indenture. If the bonds are redeemable, they may be called for sinking fund purposes at the price stated in the indenture. This price may run from par to a premium sometimes as high as 105. Bonds thus called for redemption are ordinarily drawn by lot. If the indenture so provides, registered bonds are not called until after the coupon bonds have been paid. Such a provision recognizes that a bondholder who takes his bonds in registered form is likely to be an investor who wants to put his bond away in a safe deposit vault with the feeling that his money is securely and safely invested.

A second method of acquiring the bonds permits the trustee to purchase them in the open market at a price not to exceed the call price at the time. Should the market price be too high, the trustee will not acquire the bonds in that manner.

The third method of acquiring bonds is to solicit lenders by advertising for them. Even where the right is given to purchase bonds on the open market, it is advisable to permit the company to call for bonds by advertisement. If the company goes on the market, its bids for bonds will be the signal for an upward turn, but if it calls for bonds by advertisement, the market price may remain stable and bonds may be offered at a fraction of 1 per cent above the market price. Thus all the bonds that are needed may be acquired at 100¼, whereas by going on the market, the bonds may be obtained at prices ranging from 100 to 105, with an average of 102½.

In the rare cases where the bonds of the same issue are not callable for sinking fund purposes, the indenture instructs the trustee as to how the funds shall be used if bonds are not obtainable. Sometimes the trustee may invest the funds in United States Government bonds; or

they may be left with the trustee to draw interest; or they may revert to the company.

Default in sinking fund payments—waivers. When a default is made in respect to the sinking fund, for example, where a payment is not made to the trustee as required, the provisions in the indenture pertaining to remedies upon default apply. If the indenture under which the bonds were issued conformed with the Trust Indenture Act of 1939, there would be a provision in it requiring reports by the trustee to the bondholders that would reveal the failure of the corporation to make sinking fund payments. The indenture would also provide that in case of default, as defined in the indenture, the trustee must act as a prudent man would act under the circumstances in the conduct of his own affairs.

Where sinking fund payments are obligatory, nonpayment is a breach of contract and the trustee can bring an equitable action to compel the company to meet its sinking fund obligation. Such action would be taken, of course, where the default was not due to inability of the company to meet the sinking fund requirements, but due to neglect or fraud. Where payments are not made because of inability to do so, the trustee, acting as a prudent man, might consider that it would serve the interests of the bondholders best not to attempt to enforce compliance. The trustee may hesitate to hurt the credit of the company by bringing legal action against it.

In some instances, operation of the sinking fund provisions has been deferred by agreement with the trustee and resumed upon improvement in conditions. Thus, in 1939, operation of the sinking fund of the Hudson Coal Co. first mortgage 5's due 1962 was deferred both with respect to principal sinking fund payments and interest on bonds held in the sinking fund. The fund was brought up to date in 1944 and payments were then made regularly until the bonds were redeemed in 1955. Whether a waiver can be given by the trustee in any given case depends on the power conferred on the trustee in the indenture.

Canceling or keeping alive. After the bonds of the same or a prior lien issue are obtained by the trustee, they may either be canceled or kept alive. If they are canceled, the company saves future interest payments; if they are kept alive, the company continues to pay interest on them, which interest, of course, goes into the sinking fund and thus accelerates its growth. Many examples of either method of handling the bonds can be found.[12]

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[12] The so-called sinking fund tables are built upon the principle that the sinking fund is invested in bonds of the issue and that they are kept alive These tables tell how much is necessary to be set aside periodically with interest to yield one dollar at the end of any number of periods.

Sinking fund and serial bonds. At page 110 it was pointed out that bond issues are sometimes created with serial maturities so that a fixed number of bonds fall due annually instead of the entire issue falling due on a single date. Since sinking funds are usually invested in bonds of the issue that they protect, a sinking fund bond is very much like a serial bond. Important differences exist, however. Before we point out those differences, let us examine the motives for issuing serial bonds.

Different reasons actuate corporations in issuing serial bonds. In the field of equipment trust financing, where serial bonds have been used most frequently, the serial arrangement provides a means for financing recurring demands. Take the purchase of railway equipment as an example. Serial bonds are used for this purpose, but a railway will at any one time have a number of series outstanding, each issue numbered with a letter of the alphabet. Thus, at the time of this writing, Southern Railway Co. has outstanding equipment trust obligations lettered "NN," "OO," and so on through "TT." In cases of this kind, a fixed number of bonds are retired annually by virtue of the serial maturities, and the interest burden on each issue decreases each year. As new or additional equipment is needed a new serial issue of equipment trust bonds is brought out. The consecutively issued serial bonds, each involving a decreasing annual burden, tend to equalize the annual burden when taken together. The serial arrangement is also suitable for equipment financing because the rolling stock that constitutes the security for the issue necessarily must be exhausted and cannot well be kept up to original value by repairs.

In the industrial and public utility fields, serial bonds have been used in recent years to permit the issuers to retire newly created bond issues that they do not wish to continue to have outstanding. If refunding were anticipated, the company would issue sinking fund bonds rather than serial bonds. Also, market conditions may influence the choice of serial bonds as against sinking fund bonds. When the public wants long-term bonds, the company is likely to issue sinking fund bonds; when it is eager for short-term securities, the borrower may decide upon serial bonds.

Differences between sinking fund and serial bonds. We are now ready to compare serial and sinking fund bonds from the corporation's and the investor's viewpoints. One basic difference applies to both. In the case of the sinking fund bond, no one can tell at the time of issue whether bond Number 1 will be retired through the use of the first installment of the sinking fund or whether it will remain outstanding till final maturity of the whole issue. In serial bonds, on the other hand, everyone knows that bonds numbered, say, from 1 to 100, will mature in one year, those numbered 101 to 200 in two years, and

so on. This apparently slight difference is more important than it seems. We may assume two issues of bonds, each for $1,000,000: one issue, which we call "A" bonds, is protected by a sinking fund providing for the setting aside of $100,000 a year out of earnings to be used to retire bonds of the issue at par; the other, called "B" bonds, we may assume is a serial issue of the same amount, the series consisting of 10 groups of $100,000 each, one group maturing each year. The "A" bonds would be regarded as a ten-year investment. If the company should neglect to set aside the $100,000 in any year for the sinking fund, the bondholders might not be aware of this fact, and if the trustee were lax, the entire issue might run to maturity without the protection of the sinking fund. However, the bondholder of a serial issue knows definitely when his money should be returned, and if it is not forthcoming on the due date, he can enter immediate protest to the trustee. Of course, if the indenture under which the bonds were issued conformed with the Trust Indenture Act of 1939, there would be a provision in it requiring reports by the trustee to the bondholders, which would reveal the failure of the corporation to make the sinking fund payments. (See page 108.)

Another fundamental difference is in the techniques for retirement of the bonds. In the serial issue, the obligation is paid off in the same way as any redemption of a maturing obligation. In the sinking fund issue, the bonds to be retired may be called for redemption or purchased on the market.

From the corporation's viewpoint, these additional differences between serial and sinking fund bonds may be noted: (1) The corporation may be able to borrow at a lower average cost by issuing serial bonds, which will include some bonds with short maturities, than by issuing sinking fund bonds with a single medium- or long-term maturity. This would happen, for example, when short-term money is lending at a much lower rate than long-term money. Sometimes a serial issue has two or three different coupon rates: a low rate on the earlier maturities, another rate on the intermediate maturities, and a third and higher rate on the longer maturities. See the example at page 110 of a serial bond issue with numerous coupon rates. This arrangement helps to keep the prices of the several maturities nearer to par.

(2) Because of the differences in bondholders' attitudes toward default in payment of an obligation at maturity and default in sinking fund payments, the serial maturities create a more rigid obligation than the sinking fund requirements. (3) Serial bonds can be sold in a broader market than sinking fund bonds because some investors look for securities with early maturity dates and others want late maturity dates. Commercial banks, for example, may want bonds with

an early maturity date such as the serial bonds offer. (4) The corporation pays par on retiring the serial bonds, but may have to pay a premium for the retirement of the sinking fund bonds if they are called for sinking fund purposes. On the other hand, if the bonds have declined in price on the market, the corporation may realize a profit by purchasing its bonds for sinking fund purposes at a discount.

From the investor's viewpoint, these differences may be noted: (1) The purchaser can select from the issue of serial bonds the maturity that meets his investment needs. In the case of sinking fund bonds he does not have this choice and may find that a bond he bought for long-term investment is called for sinking fund purposes shortly after he acquires it. (2) The market price [13] of a serial bond is not directly affected by its fixed retirement date, with its payment at par. The price of a sinking fund bond might be affected because retirement is uncertain and the operation of the sinking fund may narrow the market for the bonds. On the other hand, sinking fund purchases might improve the marketability of the bonds or at least help to maintain the price around the redemption figure. (3) As each group of serial bonds is retired, the equity behind the remaining bonds increases. The same may be said of sinking fund bonds if the payment is used to retire immediately bonds of the same issue. However, the debt reduction is more certain in the case of serial bonds.

Combination serial and sinking fund bonds. Sometimes a serial bond will be protected by a sinking fund in the same way that bonds without serial maturities are. The Hanchett Mfg. Co. first convertible 5½'s, Series A, due serially to 1964, require an annual sinking fund payment in an amount by which 25 per cent of net earnings exceeds maturity payments. The additional protection of the sinking fund compensates for any serious reduction in the value of the assets behind the bonds due to extraordinary depletion or wear and tear that might result from an unusually high rate of operations.

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[13] Because of the differences in maturities of the various groups in the serial bond issue, on original issuance the various groups are sold at different prices to approximate the same yield. In a very rough way, if a group of 5 per cent bonds maturing in one year sells at 98, the group maturing in two years will have to sell at 96 to give the same yield, for in each case the yield would consist of 5 per cent of nominal interest and $2 a year through appreciation of the principal investment, which will be worth par at maturity In practice, of course, the calculation is made with great nicety. Thus, an issue of 5½ per cent serial bonds made in 1944 and due serially to 1964 was offered at 99½ to 102½ to place all the bonds with varying maturities on a uniform yield basis. Except when the serial bonds are selling at par, they are very often quoted on a yield basis; that is, on the basis of the rate of income return instead of the percentage of the principal amount. Thus, a serial bond would be quoted as selling at a 4.70 yield rather than at a price of 96½.

Research Question

From your daily paper, or from any other source, determine the price of the Consolidated Edison convertible bonds and of the common stock. The conversion rate is 40 shares of stock for each bond. Does this work out in accordance with the theory?

Problem

The Adams Corporation has issued 3½ per cent bonds convertible into stock at 50. At present the stock is selling for 45 and paying an annual dividend of $4.50. The bonds are selling at 101⅞. Prospects for the year look good, and it is believed that the company might declare an extra dividend of $.50. Assume that you own a $1,000 bond:

(a) Would there be any reason to convert now?
(b) At what price would the stock have to sell in order to be at the conversion point?
(c) If the stock went to 60, what would happen to the bond?
(d) What would be the current yield (not yield to maturity) in part (c)?

CHAPTER 9

Capitalization and Capital Structure

When problems of capitalization and capital structure arise. As was pointed out at page 72, capitalization comprises a corporation's ownership capital and its borrowed capital, as represented by its long-term indebtedness.[1] Capital structure refers to the kinds of securities that make up the capitalization. Problems of capitalization and capital structure generally arise (1) when a corporation is organized, (2) when it is in need of additional capital because it has grown and is planning for future growth, (3) upon merger or consolidation with other existing corporations, and (4) upon recapitalization, readjustment, and reorganization.

In any of these situations two basic questions are: (1) what amount of securities shall be issued? (2) what kind of securities shall be issued? Decisions as to amount of securities are reflected in the capitalization; decisions as to the kind of securities are reflected in the capital structure. The basic principles that apply in answering these questions are treated in this chapter. However, the discussion is confined to the first and second situations; that is, the organization of a new business and the expansion of an existing one. The application of principles of capitalization and capital structure to consolidations will be treated in Chapter 23. The problems of capitalization and capital structure that arise in recapitalization and readjustment will be covered in Chapter 26, and those that arise in reorganization, in Chapter 27.

We shall discuss first the basis of capitalization and then the principles governing capital structure. The separation of these two subjects for purposes of this explanation is not intended to give the impression that management arrives at a total amount of capitalization

[1] At page 72, it was pointed out that surplus is often considered a part of the total capitalization.

and then determines its capital structure. Actually what happens is that management estimates the amount of capital that will be required and then tries to figure out how to raise that amount of capital. In making its deals with those who will supply the capital, it arrives at the capitalization and the capital structure.

The earnings theory of capitalization. Fundamentally, a business is a profit-making entity and is worth what it will earn. Obviously, this does not mean that if a business has net earnings of $50,000 a year it is worth only $50,000, for the business presumably will keep on earning. It means that it is worth its annual net earnings times an appropriate multiplier. To determine the appropriate multiplier it is necessary to arrive at the rate of return that is required to attract capital to the particular corporation. The multiplier is 100 per cent divided by the appropriate rate of return. Thus, if investors will not put money into a venture unless they can get a return of 8 per cent, the multiplier is 12½; if they want 20 per cent, the multiplier is 5. Two factors, then, enter into the determination of capitalization: (1) what the business is capable of earning, and (2) what is a fair rate of return for capital invested in the particular enterprise. The earnings divided by the rate of return, or to put it another way, the earnings times the appropriate multiplier, gives the amount of capitalization based on earnings. For example, if a business is capable of making net profits of $50,000 annually and 8 per cent is a fair rate of return for the kind of business, the capitalization based on earnings would be $625,000 ($50,000 divided by 8 times 100, or $50,000 multiplied by 12½).

Let us see how earning power and rate of return enter into a practical situation that involves capitalization. *A* owns a laundry that has been operating successfully for four years. He wants to sell the business and is asking $50,000 for it. *B* is interested in buying it. *B*'s first inquiry of *A* is how much the business nets each year. *A* shows *B* his records of income and expenses and convinces *B* that the business yields a net of $5,000 a year. On the basis of the asking price, the rate of return is 10 per cent. *B* thinks that the rate is too low because he is taking the risk that a competitor will open up in the neighborhood and cut into the profits of the business. *A* is eager to sell and the two men bargain over the price. They finally agree upon a payment of $30,000 for the business and the deal is made. The capitalization of that business when taken over by *B* is $30,000. Earnings have been capitalized at 16⅔ per cent; in other words, the business is capitalized at six times earnings.

The cost theory of capitalization. Under the cost theory, the corporation's capitalization is based on the cost of the fixed capital employed in the business (investment in plants, machinery, patents, and

the like), the amount of regular working capital required to run the business, the cost of establishing the business, and other costs. Although these factors enter into any estimate of capital needs of a new corporation, as we shall see when we study promotion in the following chapter, they do not provide an adequate basis for capitalization of a company with irregular earnings, such as an industrial or mercantile business. For example, if some of the fixed assets stand idle, become obsolete, or are poorly employed, earnings will be low and the company will not be able to pay a fair return on the capital invested. The result will be overcapitalization.

For public utilities and railways—companies enjoying monopolies against which the public must be protected by rate-making bodies—the capitalization must have a relation to the value of the assets. Then, in regulating rates to yield a fair return on the value of the property,[2] a fair return to stockholders is assured. If rates are so high as to yield more than a reasonable dividend on the stock, the excess can be kept in the company and used to extend the company's property and improve it—all to the advantage of the consuming public. To be sure, if this practice were permitted to be carried too far, one generation of consumers would pay the way for succeeding generations; moreover, the practice would open the way to unprofitable expansions.

Estimating probable earnings and the rate of capitalization. When a corporation estimates its initial capital needs, it also draws up an estimated profit and loss statement for the first years of the corporation's life. To make the earnings estimates, volume of sales must be predicted as well as the cost of sales and operating and other expenses necessary to bring about the expected sales. Indeed, the two estimates —capital needs and earnings—whether made by a new company or one in existence, are usually interdependent. The sales estimate is arrived at on the basis of forecasts of business conditions in the country as a whole, in industries that will buy from the firm, and in the field which the corporation is entering. These forecasts are related to the scale of operations that the corporation is to undertake. The costs are determined from the managers' knowledge of material costs, labor costs, and other operating expense factors. The estimated earnings figures are compared with actual earnings of other companies engaged in the same business. Allowances, of course, must be made for differences in size, age, location, managerial experience, rate of growth,

[2] The elements determining rate-making values for the railroads are: (1) original cost of the properties; (2) cost of reproduction new; (3) cost of reproduction less depreciation; (4) present value of lands and rights, (5) working capital. 275 I. C. C. 59 (1949).

The question of valuing the stockholders' investment in public utilities is not touched upon in the text, for the author feels that it is too large to be treated here even in outline.

and similar factors in any such comparison. Obviously, even the best-intentioned promoters may make mistakes in their estimates; that is one of the reasons why investors are wary of new security issues offered for sale by new organizations.

In estimating the rate of return on total invested capital, a study must be made of what other corporations in the same industry, and similarly situated, are earning on their capital. Also, the rate at which the market is capitalizing earnings for such companies must be taken into account. For example, suppose that the market prices for the securities of the companies whose earnings are being studied for comparative purposes show that investors are currently paying only four times earnings for the shares. Suppose further, that this low price-earnings ratio is entirely out of line with the actual rate of return on capital invested in the companies. Nevertheless, if market conditions showed that investors were willing to pay only four times current earnings for a stock issue, the capitalization rate would have to reflect this condition even though other factors supported a higher multiplier, that is, a lower rate of return.

Over- and undercapitalization. A corporation is *overcapitalized* when its earnings are not large enough to yield a fair return on the amount of stocks and bonds that have been issued, or when the amount of securities outstanding exceeds the current value of the assets. A corporation may be *undercapitalized* when the rate of profits it is making on the total capital is exceptionally high in relation to the return enjoyed by similarly situated companies in the same industry, or when it has too little capital with which to conduct its business. The overcapitalized company has a serious problem on its hands; the undercapitalized company may be a highly successful one or it may be one facing financial difficulties. The causes and remedies of over- and undercapitalization will be treated briefly here since they will come up again in other chapters.

Over- and undercapitalization in relation to earnings. Overcapitalization may result from having overestimated earnings or from having capitalized correctly estimated earnings at a too low rate. For example, suppose it is estimated that the corporation will earn $150,000 annually and that 5 per cent is a fair ratio between the earnings and the cost of the business. The earnings capitalized at 5 per cent will give a capitalization of $3,000,000. The corporation will issue stock in the amount of $3,000,000 for property, cash, or services. The consideration it receives for this stock will appear in the balance sheet as the assets of the corporation. If it should develop that the corporation can earn only $100,000 annually, instead of $150,000, it is immediately evident that the corporation will not be able to pay 5 per cent on the investment of the stockholders. The result is that the corporation

is overcapitalized. At 5 per cent the correct capitalization would be $2,000,000.

Suppose, now, that when the corporation had capitalized its expected earnings of $150,000 at 5 per cent, that rate was sufficient to induce investors to buy the offered securities. Later it develops that companies circumstanced such as this one cannot command capital at less than 8 or 10 per cent. In that case, even if the company could earn $150,000 annually, its capitalized earnings would warrant an issue of stock of not more than $1,500,000 to $1,875,000.

Whether the overcapitalization arises from overestimating the earnings or from using too low a rate of return, the result is the same: the stock will fall below the purchase price, in the first instance because the stockholders will not receive the dividends they had been promised, and in the second instance because a 5 per cent rate is less than what money invested in such a company should bring.

Obviously, if earnings are underestimated, or if the rate used is too high, the company will be undercapitalized.

Over- and undercapitalization in relation to assets. The discrepancy between the asset value and the capitalization of an overcapitalized company may arise from any number of causes. For example, the stock may have been watered on original issuance by overvaluation of intangible or tangible property received in exchange therefor.[3] This situation, as we saw at page 87, may arise through an attempt to make par value stock issued to promoters fully paid. Or, the overvaluation may have resulted from pursuing an improper depreciation policy or because of a declining price level.

In an undercapitalized but successful company, whose stock is selling at a high price, the assets of the company may be worth considerably more than the values reflected on the books. This condition might exist because of an undervaluation of property for which stock was issued, too liberal depreciation allowances, or a rise in the general price level—conditions exactly the opposite of those that cause overvalua-

[3] The Securities Act of 1933 does not prohibit stock watering. Its purpose is to require a full disclosure of the essential facts concerning the securities offered, and to prevent fraud and misrepresentation in the sale of securities. The Securities and Exchange Commission has issued stop orders against the sale of stock where conclusions of value reached by experts were challenged because of unsound methods, inadequate investigation, failure to disclose a proper method of valuation, or because the result expressed was inaccurate. It has held in many cases involving promotional enterprises that "values assigned to intangible assets acquired in exchange for stock must be scrutinized with care to avoid a misleading result in the financial statements due to the presence of inflated or improperly classified asset accounts." Securities and Exchange Commission, *14th Annual Report,* 1948, p. 109. The requirements that the registration statement disclose the expert's interest in the issuing company and that the financial statements be certified by an independent public accountant tend also to prevent the fraudulent issue of watered stock. More is shown of the Commission's activities in preventing fraud at pages 226 and 276.

tion. Undercapitalization that results in too little capital may have no relation whatever to the method or basis of valuation of assets owned by the company, but may be due to improper estimating of the capital needs of the business.

Remedies for over- and undercapitalization. When over- and under-capitalization threaten, or result in, financial difficulties, recapitalization and readjustment of capital structure are necessary. How this is done will be explained fully in Chapter 26. Some of the remedies will be mentioned here only briefly.

One remedy for overcapitalization due to overvaluation of assets is to squeeze the water out of the stock by putting the earnings of the company back into the business until adequate protection is provided for the common stock. Another remedy is to reduce the amount of stock outstanding. This generally involves an amendment to the certificate of incorporation and obtaining the consent of the stockholders when they are asked to surrender such proportion of their stock as the amount of the proposed reduction bears to the whole amount of the capital stock. A common method is to reduce the par value of the shares, or, if stock is without par value, to reduce the number of shares outstanding.

A simple remedy to reduce the price of the stock of an undercapitalized, successful company, without changing capitalization, is to split the shares and reduce the value of each share in accordance with the rate of the split-up. This may be done, in the case of par value shares, by reducing the par value and exchanging each share for a proportionately larger number; for example, exchanging each $100 par value share for four shares with a par value of $25 each. Or the shares may be changed from par value stock to no-par value stock and a certain number of the no-par shares be issued for each share of par value stock. In the case of no-par stock, a reduction in market value is accomplished by a split-up or by the declaration of a stock dividend.

Declaration of a stock dividend is another common method of remedying undercapitalization where a surplus has been accumulated, or where conditions warrant writing up the value of the assets to create the surplus from which the stock dividend will be declared. The purposes and effects of a stock dividend will be explained fully in Chapter 20.

Is stock-watering ever justified? Many commentators on corporation finance, especially theoretical economists, overlook the full significance of the distinction between present and prospective earning power as bases for corporate capitalization.

In the discussion of par value stock at page 87, the illustration was given of a mine owner whose mine, according to geological reports, contained $10,000,000 of ore which could be extracted at a cost of

$4,000,000. He turned the mine over to a corporation for $6,000,000 of fully paid par value stock and then gave back $2,500,000 of the stock to the corporation to be sold to other investors as treasury stock at less than par. Has this mine owner confessed to overcapitalizing his company by his act of turning over 40 per cent of his capital stock? His purpose has been to turn his potential "purchasing power," as it existed in the form of unextracted metal, into active purchasing power by giving others some inducement to supply the funds necessary to begin operations. The people who supply the funds take great risks: first, on the accuracy of the geological reports; second, on the possible occurrence of unusual and unforeseen difficulties in operation; and third, on the continued integrity and ability of the managers. On this last point it may be observed that the original owners, to turn their property more quickly into active purchasing power, may sell out their holdings to persons of doubtful integrity and ability. A small purchaser of securities ordinarily has no guarantee that the majority interests will not change hands. Hence the risks are great and the person taking the risks will demand an offsetting advantage. This he gets in buying the treasury stock much below par. By taking treasury stock below par instead of unissued stock below par, the holder avoids complications with creditors. If the company prospers, the stock will rise in value and the original purchaser will receive the reward of his risk-taking.

Stock issued for prospective earning power always affords a method of isolating the speculative element in an enterprise. Funds can be more readily raised through such a separation. In the first place, the speculative securities—common stock—may be sold to persons who are ready to assume the risks involved. If the proceeds of these shares go into the company, they form an "equity" behind the non-speculative securities—preferred shares or bonds—and the latter are therefore sold on better terms to the investing public, for the equity provides a sort of guarantee of safety. If the proceeds go to the promoters and bankers, they prevent an equivalent amount from being taken from the proceeds of the sale of securities that are non-speculative in appearance—for the promoter and the banker must get compensation from some source, else they cannot "carry on."

Keeping down the annual cost of capital—major objective. In planning to raise capital, the corporation's major objective is to obtain the funds it needs at the lowest cost in terms of interest, dividends, and the relationship of earnings to the price of the stock. (Other objectives are mentioned at page 176.) That is why corporations, in general, raise capital by borrowing when interest rates are low and by selling equity securities when the earnings-price relationship of stocks is high. Bonds are always a lower-cost security to a corporation than stocks

because the purchaser of bonds sacrifices size of income for safety of income. Also, so far as the corporation is concerned, it can deduct the interest paid on bonds as a business expense in arriving at its income tax, thus further reducing the cost of the capital. The corporation can take no such deduction for dividends it pays on stock. Bonds, of course, should never be used where there is any danger that the interest cannot be met regularly.

Let us assume, to illustrate the principles set forth in the previous paragraph, that a corporation is trying to decide whether it should retire 4½ per cent preferred stock from the proceeds of 3¼ per cent bonds, that is, whether it should substitute 3¼ per cent bonds for 4½ per cent stock.[4] The answer to the problem is a paradoxical statement: if the company can surely pay annually the larger item—the 4½ per cent dividends—then it ought to decide in favor of the smaller item—the 3¼ per cent interest; but if there is any danger that the company will not be able to pay the smaller item, then it ought to favor the larger item. It must have "safety first," but having that, it must next try to keep down the costs—an apt illustration of the saying, "the curse of the poor is their poverty."

Keeping down annual costs of capital is not so important where new securities can be sold to old stockholders. If a company is earning 40 per cent on its stock, it will not wish to share these earnings with new investors; the high rate of earnings is probably a just reward to the old stockholders who took all the original risks of the business. If new stockholders are to be brought in now on a reasonable basis, they ought to pay $400 or $500 a share for their stock. Or the company might write goodwill into its assets and declare a 300 per cent stock dividend to its old stockholders and then sell stock to outsiders at par. These expedients might be considered instead of the expedient of reducing annual cost by issuing bonds; they would hardly be as effective. But if the company could sell its stock to the old stockholders, each taking new shares in proportion to his holdings, the earning power would be kept "in the family"—there would be no dissipation of income among recent comers. However, even where the profits can be kept in the family, when a company has stable income and is successful it can afford to take the risks of issuing bonds, for by "trading on the equity," the return on the owners' capital is magnified. This principle of trading on the equity will be explained more fully, for it is fundamental to an understanding of the use of borrowed funds as against equity capital.

Trading on the equity—a basis for funded debt in capital structure. When a person or corporation uses borrowed capital as well as

[4] In 1957, Chicago Railway Equipment Co. redeemed its 7 per cent preferred by issuing in exchange 6⅓ per cent debentures due 1986.

owned capital in the regular conduct of its business, he or it is said to be "trading on the equity." If a company is reasonably sure to earn more on borrowed money than it pays out in the form of interest on the debt, it can profitably borrow and continue to borrow. The reason for this conclusion is that in trading on the equity, gains are magnified; but so are losses.[5] For example, if a company is able to earn 10 per cent on capital, and if it can borrow money at 5 per cent, it can earn 5 per cent on the other people's money, and if its capital is half owned and half borrowed, the return on the total capital will give the company a yield of 15 per cent on its own capital. On the other hand, if the earnings fall below 5 per cent on its total capital, owned and borrowed, the income on its owned capital will be less than the earnings on its total capital, for the company will be compelled to pay 5 per cent interest on the money borrowed whether it has been earned or not. The principle can best be illustrated in the following table. It is assumed in the upper part of the table that the company is in business with $100,000 on which it earns, in the first year, 10 per cent, and in the second and third year, 15 per cent and 3 per cent, respectively. In the lower part of the table is shown what would have happened to the company if it had borrowed an additional $100,000 at 5 per cent.

ILLUSTRATION OF TRADING ON THE EQUITY

	First Year	*Second Year*	*Third Year*
Where $100,000 owned capital is used:			
Earnings	$10,000	$15,000	$3,000
Per cent on $100,000	10%	15%	3%
Where $100,000 owned capital is used, and in addition $100,000 is borrowed at 5%:			
Earnings	$20,000	$30,000	$6,000
Interest	5,000	5,000	5,000
Net earnings	$15,000	$25,000	$1,000
Per cent on $100,000	15%	25%	1%

Limitations on policy of trading on the equity. Trading on the equity is conditioned primarily by stability and certainty of earnings.[6] If a

[5] The term "leverage" is sometimes applied to indicate that there is a large amount of borrowed capital or preferred stock with which to operate to the benefit or detriment of the common stockholders.

[6] The following mathematical computation shows that the more stable the gross income the greater may be the amount of borrowing. In order to follow the demonstration, which is in fact very simple, two expressions, "operating ratio" and "financial ratio or risk," must be understood. Operating ratio is the ratio of operating expenses to operating revenues. Financial risk is the ratio of the interest charges to the sum available for the payment of interest charges—that is, the net income left after subtracting the operating expenses from the operating revenues.

company has fluctuating income, it runs great risk of being unable to pay its interest during lean years and of bringing on a receivership with all its difficulties and losses. Management must always ask how much debt the company can stand during adverse conditions without becoming financially embarrassed. In other words, during bad business conditions, will the company be able to meet the interest charges, and if the bond issue should mature when business is poor, will the company be able to meet the maturity without a strain? Public utilities, with their relatively stable earnings, can much better afford to borrow than can industrials. Furthermore, their heavy investment in plants and their long-term growth trend make it feasible for them to undertake a certain amount of fixed charge financing.

Another limitation to borrowing of fixed funds is that successive sums are ordinarily borrowed at higher rates of interest because each new sum that is advanced involves the lender in greater risk. This, of course, limits the profitability of borrowing. Bonds should never be used unless the estimated earnings will give a "factor of safety" of at least 100 per cent. Factor of safety is the ratio of the amount of interest to what is left after paying the interest.

The significance of the factor of safety is brought out in the following hypothetical example. Suppose a concern makes a net income of $400,000 in an average year, that its gross income is $1,000,000, and that the company has a mortgage debt on which it pays interest of $125,000. Let us see how this company would cover its fixed charges by a liberal margin in a good year and by close to the minimum factor of safety in a poor year, when gross income drops 20 per cent. Then

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Let a = operating revenues in normal year.
b = decrease of operating revenues in the poorest year.
m = operating ratio (ratio of operating expenses to operating revenues).
x = financial risk, that is, the largest possible risk that can be met in any (that is, the poorest) year.

	Normal Year	Poorest Year
Operating revenues	a	$a - b$
Operating expenses	am	$(a - b)m$
Net income	$a - am$	$(a - b) - (a - b)m$
Fixed charges	$x(a - am)$	

The quantity $x(a - am)$ is unknown, since one term is unknown. Whatever it amounts to, it is by its very nature constant, that is, it will not vary from year to year. It should not be larger than the net income in the poorest year, but it may be as large; in other words, it may be equal to the net income. Thus $x(a - am) = (a - b) - (a - b)m$. Factoring and solving for x:

$$x = \frac{(a - b)\ (1 - m)}{a\,(1 - m)} = \frac{(a - b)}{a}$$

That is, the financial risk (x) may be equal to the ratio of the operating revenues in the poorest year ($a - b$) to the operating revenues in the normal year (a).

let us see how additional debt involving $62,500 more of interest would cause the minimum factor of safety not to be achieved in poor years.

Thus it will be seen that although in a normal year the factor of safety was more than maintained when the debt was increased, in a poor year the additional debt caused the factor of safety to fall close to the danger line.

(a) Debt involving interest of $125,000:

	Normal Year	*Item*	*Poor Year*
Gross income	$1,000,000	*A*	$800,000
Operating expenses	600,000	*B*	552,000 [7]
Income from operations	$ 400,000	*C*	$248,000
Interest on mortgage	125,000	*D*	125,000
Net income	$ 275,000	*E*	$123,000
Factor of safety (E:D)	220%		98%

(b) Debt involving interest of $187,500:

	Normal Year	*Item*	*Poor Year*
Income from operations	$ 400,000		$248,000
Interest on mortgage	187,500	*F*	187,500
Net income	$ 212,500	*G*	$ 60,500
Factor of safety (G:F)	113%		32%

Managerial limits to borrowing. The corporation may be strong enough to raise funds by issuing bonds, and it may even be able thus to acquire capital more cheaply than by issuing stock, but for any one or more of the following reasons it will decide against bond financing:

1. It has a general aversion to contracts containing rigid provisions as to future payments to investors.

2. It wants to maintain a high credit rating for all of its securities and thus assure lower financing costs over the long run.[8]

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[7] Operating expenses ordinarily do not vary directly with the gross revenues. A little more or a little less business will probably have no effect at all on the operating expenses because certain expenses, for example rent, depreciation, and office salaries, are fixed in amount for a given level of operation. In the assumption above, it was reckoned that only 40 per cent of the operating expenses are variable; that is, instead of the operating expenses shrinking by a full 20 per cent, they would shrink only 20 per cent of 40 per cent, or 8 per cent. Thus we decreased the operating expenses by 8 per cent of $600,000, or $48,000. The subject of variable expenses is discussed more fully in Chapter 17.

[8] Although in the post-war years there was little difference in the yields of top quality bonds and lower grade bonds, in other periods the spread has been considerable. This shows that companies with low grade bonds normally have to pay more for their borrowed capital. In 1938, for example, the average yield on industrial bonds graded Aaa was 3 per cent while that on bonds graded Baa was 4 per cent. In 1931, 1932 and 1933 the spread was even greater. In 1946 it was ½ of 1 per cent. In 1955 it was about 7⁄10 of 1 per cent.

3. It has an expansion program and recognizes that it is poor policy to indulge in debt financing as against equity financing merely because the cost of selling the senior securities is cheaper. It knows that the time will come when stock must be sold regardless of its cost to the corporation.

If the corporation is subject to supervision by a regulatory body, such as a public service commission, a railroad commission, or the Interstate Commerce Commission, that body, by refusing to approve of the issuance of bonds, may practically set the limit of funded borrowing. Its decision may be made on the basis of what the proceeds are to be used for and what it considers a fair and wise capital structure for the corporation. In the reorganization of the railroads, for example, the tendency has been to reduce the ratio of bonded indebtedness to equity securities because one of the chief causes of railroad bankruptcy has been the burden of fixed charges. Except in cases where the road has very poor prospective earnings, it is debatable whether too great a reduction of fixed debt is entirely desirable. It eliminates the possibility of the corporation profiting by trading on the equity.

Relation of amount of borrowing to rate of interest. Companies cannot afford to borrow much when they have to pay high rates of interest for the borrowed funds. In fact, when money is scarce and interest rates are high, borrowers ordinarily reduce their borrowings to a minimum and arrange the contract of loan for a short period only.

Interest rates are fixed not only by demand for and supply of funds, but by the risk that the lender takes in committing his funds to a particular borrower. For this reason, old, well-established concerns can borrow more freely than young concerns whose reputations have not been established. Moreover, the nature of the business will have some effect; public utilities, for example, ordinarily pay a much lower rate than industrials, because the earnings of the former are more stable.

A small difference in interest rates does not seem important at first glance, but if the saving effected by the difference in rates is accumulated at compound interest over the life of the bonds, it will amount to a substantial sum. For example, assume that a $1,000,000 bond issue running for 30 years could be sold at 3 per cent instead of 4 per cent. The saving is $10,000 (1% × $1,000,000) for each year that the bonds are outstanding. If the amount saved were deposited each year at compound interest of 2½ per cent, the total saving over the term of the bond would amount to $439,027.

Other objectives in raising capital. The principal objective in raising capital, we have seen, is to pay as low a rate for the use of invested or borrowed capital as possible. Other objectives should be:

1. *To have a conservative capital structure.* A conservative capital structure is one made up of high-grade securities. Conservative capi-

talization is always wise policy because it offers the corporation the following advantages: (1) Over the long run, the cost of financing will be less. (2) The corporation can raise funds even in bad times. (3) The company can sell whatever type of security is best suited to the market when the need for funds arises.[9] (4) It can meet unforeseen difficulties without disaster. (5) Good relations are maintained with security holders.

In carrying out this objective, the corporation will consider, before it selects the form of securities to be issued, the effect of the proposed securities not only on the company and its credit at the moment of issue, but on the value of its other securities, on the possibility of issuing other securities in the future, on the availability of future earnings for dividends to keep up the company's investment credit position,[10] and on the possibility of rearranging the financial structure of the company in the future.

2. *To have as flexible a contract between the security holder and the corporation as possible.* Management prefers the least possible rigidity as to payments that it must make in the future. This condition allows it maximum freedom of action in financial management. Thus, it would ordinarily prefer to sell common stock to preferred stock because there is more leeway in the declaration of dividends on common stock; and it would prefer common or preferred stock to bonds because the consequences of not paying dividends are less serious than failure to meet interest or principal payments on bonds. Default in bond obligations, we have already seen, usually results in financial failure of the corporation and reorganization.

3. *To have a simple capital structure.* Other things being equal, a simple financial structure is to be desired because it is easy to manage, and because it avoids the suspicions that unnecessary complexities arouse. One class of stock and one issue of bonds under one mort-

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[9] The Portland Gas and Coke Company included the following comment in its 1955 annual report: ". . . It is probable that the required financing will be done through the sale of debenture bonds, bank loans, mortgage bonds, and common stock in the order named. . . . The strong equity position and the fact that the Company has no preferred stock in its capital structure makes possible considerable leeway in financing construction requirements for natural gas operation." The company's capitalization consisted of 37 per cent debentures, mortgage bonds, and long-term notes, and 63 per cent common stock and surplus—a very conservative capitalization for a utility operating company.

[10] For example, if a company is relying largely on the sale of bonds under a limited open-end issue, it may be required by the escrow clauses to pay for a part of the cost of new property acquired in some way other than from the proceeds of the bonds. Unless the company is in a position to sell stock, it will have to use its earnings to supply the required "equity." Plowing earnings into the property in this way prevents the payment of cash dividends, depresses the value of the company's stock, forces financing through the single channel of the bond issue, and makes the capital structure lop-sided with bonds.

gage make for a clear understanding on the part of investors of the rights they are buying when they take the company's securities. The tendency in recent years has been toward simplified capital structures.

4. *To retain control.* New securities should not be issued in such a way that control will be given away. If stock is issued and all the old holders of stock participate in the new issue in proportion to their old holdings, relative control will not be affected. But the amount of new funds needed may be too large for the old holders to supply, or the latter may wish not to add so large an investment in one enterprise in which they already have large commitments. The use of bonds or stock without voting power will settle the problem.

5. *To keep the best security to the last.* Managers of corporate financing operations must always think of the rainy days, of the emergencies.[11] The general rule is to keep your best security or some of your best security till the last. Unissued bonds under a limited open-end issue are generally available in very large corporations and these may be made more attractive in times of great necessity by being deposited to secure short term loans. Smaller companies can use ordinary real estate mortgages, or, if they have financed themselves in the past entirely with stock, may create a general corporate mortgage.

6. *To keep down the cost of selling the securities.* The sale of an issue of securities involves certain costs some of which may vary with the type of security. These costs will be examined when we discuss distribution of new securities in Chapter 12. Here it is sufficient to say that usually the corporation incurs the lowest expense in selling a bond issue and the highest expense in marketing common stock. The most important item in the selling costs is the compensation paid to the investment banker, also referred to as the underwriters' commission or spread. The measure of this cost is the difference between the price at which the securities are sold to the public and the price that is paid to the issuer by the investment banker. Other selling expenses include the cost of registering the securities with the Securities and Exchange Commission, listing fees, taxes, printing and engraving costs, legal fees, accountants' fees, and other fees.

Patterns of capital structure. The basic patterns of capital structure are:

1. One class of stock, usually common stock. It is often called just "capital stock," the term "common stock" being reserved for use when there is more than one class of stock.

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[11] We are not speaking here of emergencies in respect to working capital, but of emergencies that demand rush investments of capital funds. An example of what we have in mind is the funding of a large floating debt incurred during rapid expansion in a period of great business prosperity—for example, in the years immediately following World War I and World War II.

2. Common and preferred stock.
3. Common and preferred stock and bonds.

The patterns vary considerably for different types of corporations—industrials, public utilities, and railroads—not only as to the type of securities that make up the capital structure but as to the ratio of funded debt to equity securities. Within each type of corporation, too, there are variations in the patterns. Thus, manufacturing corporations have a different capital structure as a group, from merchandising or extractive businesses. Three tables are given below to show the differences in patterns for three types of corporations, manufacturing, railroads, and electric utilities. In the case of manufacturing corporations, the figures show the influence of size of the business. The data in Table I are not comparable with those in Tables II and III, since capital surplus is included with capital stock in Table I, and not in Tables II and III.

TABLE I

LIABILITIES AND STOCKHOLDERS EQUITY
(4th Quarter—1956) [12]

	Assets range (Millions of dollars)				
	under ¼	*¼ to 1*	*10 to 50*	*100 to 250*	*1,000 and over*
Current liabilities	36.7%	32.4%	24.2%	24.3%	19.4%
Long-term debt—bank loans	1.7	1.8	2.4	1.8	2.1
Long-term debt—other ..	8.1	6.9	7.1	13.8	8.3
Other noncurrent liabilities	1.2	1.7	0.7	0.5	1.8
Capital stock, capital surplus	30.9	24.2	23.9	26.9	30.2
Earned surplus, surplus reserves, and reserves not reflected elsewhere	21.4	33.0	41.7	31.7	38.2
	100.0	100.0	100.0	100.0	100.0

TABLE II

CAPITALIZATION OF CLASS I LINE HAUL RAILROADS IN THE UNITED STATES [13]
(Close of 1956)

Long-term debt	37.5%
Preferred stock	5.0
Common stock	23.2
Surplus	34.3
	100.0

[12] Federal Trade Commission and Securities and Exchange Commission, Quarterly Financial Report for Manufacturing Corporations, Fourth quarter, 1956. Similar information is available for major industry groups such as food, tobacco manufacturers, textile mill products, apparel and finished textiles, lumber and wood products, and several others.

[13] Interstate Commerce Commission's "Seventieth Annual Report on Transport Statistics in the United States for the year ended December 31, 1956," Part I, p. 120.

TABLE III

CAPITALIZATION OF CLASS "A" AND "B" ELECTRIC UTILITIES [14]
(Close of 1955)

Long-term debt	50.7%
Preferred stock	12.3
Common stock	27.5
Surplus	9.8
	100.0

Over a period of years the percentages shown in the tables may vary considerably. After a long period of business prosperity, there may be less funded debt in total corporate capitalization than after the business cycle has swung downward for a time. We have already seen how in periods of rising profits corporations tend to call in their bonds and how holders of convertible securities, preferred stocks and bonds, turn in those securities for common stock. These changes are reflected in the proportions that funded debt, preferred stock, and common stock are of total capitalization. Another point to remember is that although data on the capital structure of a group of companies may show substantial percentages allocated to debt, the corporate structure of most industrial corporations is confined to equity securities, that is, one or more classes of stock. Comparatively few corporations, except in the railroad and public utility fields, have any large proportion of funded debt.

The best pattern. Many factors must be considered in determining which is the best form of capital structure for a given company; there are no ironclad rules as to what percentage of capitalization should be represented by bonds and what proportion by equity securities. Each company is an individual case. A particular ratio of debt to stocks and surplus might be healthy for one company but inadequate or over-conservative for another. These principles, however, are basic: The greater the stability of earnings, the higher may be the ratio of bonds to stock in the capital structure. Also, the capital structure should be balanced with a sufficient equity cushion to absorb the shocks of the business cycle and to afford flexibility. The factors that influence capital structure and capitalization are explained below.

Influence of market conditions. Basically, the decision of a business corporation as to the kinds of securities it will issue and sell publicly to raise permanent capital represents a reconciliation of the objectives of the management and the condition of the investment market at the time. The market for new issues of securities at any particular time mirrors the current temper of the investing public. Usually, when the business cycle is on the upswing, investors are interested in equity

[14] Federal Power Commission letter, dated July 9, 1957.

securities; on the downswing of the cycle they favor bonds. This general rule, however, may not hold true at a period when high income taxes are discouraging investment in risk capital, that is, in equity securities. Tax considerations also cause many corporations to prefer debt to equity even in prosperous times. For example, in 1956, when business was at an all-time high in sales and earnings, equity financing was comparatively low. Corporate financing consisted of the sale of $12½ billion of debt securities and only $3 billion of stock issues.[15] When risk capital is scarce, it may be virtually impossible to sell common stock, or even preferred stock; investors are looking for safe investments with fixed income, practically compelling corporations to issue bonds or postpone financing. The experience of Monsanto Chemical Company is a typical example of what might happen in such a period. To finance post-war expansion and the sales volume, the company contemplated a sale of $25 million of preferred stock, but due to unsettled market conditions the issue was postponed and not floated until 1948. To take care of its needs in the meantime the company arranged for a line of bank credit up to $25 million, extending three years.

Because of market conditions, an established company may have to use a medium of financing that it does not prefer. A new and unseasoned company may find it difficult to do any financing, no matter what type of securities is considered. Similarly, a company in an industry that has fallen into disfavor may not be able to sell any securities at a particular time because investors do not want them. If a company has been forced to raise capital by selling an unsatisfactory type of security, it must immediately formulate plans for correcting the defect in capital structure as soon as possible.

The state of the market affects not only the choice of the type of security to be issued, but the interest rate on bond issues, the fixed dividend rate on preferred stock, and the price that will be obtained for common stock. When investment funds are at a high point, institutions are eager to purchase preferred stock on terms quite favorable to the issuing corporations. As funds available for investment decrease, the institutions demand better yields and various provisions to afford greater protection to the preferred stockholders. When there is a lack of risk capital, corporations pay dearly for new capital acquired by selling stock, because investors capitalize the earnings at an unwarrantedly high rate. At such a time, a corporation might prefer to finance with bonds.

Summary of influences on capital structure. Besides market conditions, the following influences, most of which have already been referred to, affect capital structure:

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[15] U. S. Department of Commerce, Survey of Current Business, May 1957.

1. *Stability of earnings.* The volume, stability, and predictability of earnings determine whether the company can undertake the fixed obligation of interest and principal payments on bonds and the fixed rate of preferred dividends. Stability of earnings is principally a matter of how the industry behaves during the various phases of the business cycle. Some industries are much more stable than others. A company engaged in the business of rendering a necessary public service, or producing an essential product, will have more stability of earnings than one producing a luxury product. A company with stable earnings could have a high ratio of funded debt, whereas one with irregular earnings would not choose to burden itself with fixed charges. Any factor contributing to instability of income would compel the company to restrict its financing largely to common stock. Thus, a corporation in a new industry would have to depend upon the sale of stock to raise permanent capital. A new manufacturing company in need of large and expensive plants and machinery, either because the product is costly to produce—Diesel engines, for example—or because it is to undertake large-scale production, would not issue bonds because its earnings are uncertain. Newness of management alone may make profits uncertain and restrict the company to stock financing.

2. *Interest rate level.* The level of interest rates at the time that financing is planned will affect the choice of securities to be offered to investors. When interest rates are high, all financing may be costly. When funds are obtained easily, and cheaply, there is greater latitude for choice of the type of security to be used.

3. *Amount of capital required.* The problem of the kind of securities to be issued is of relatively minor importance to the closely owned corporation that will raise the required original or new capital without a public offer of securities. If the organizers have all of the funds required to start a business, there will be little need for a variety of securities. One class of stock will be issued in an amount equivalent to the stockholders' investment. On the other hand, if large sums are required at the outset, different classes of stock may be necessary to interest investors with different objectives.

4. *Nature of the assets.* Some industries that require large sums of capital for fixed assets use senior securities to raise funds; the public utilities and the railroads, for example. Others, notably steel and automobile companies, do not. A comparatively high ratio of bonds to other classes of securities would be justified in the case of the utilities not so much because of the nature of the assets, but because of the stability of earnings in the industry.

Advantages and disadvantages of basic capital structure patterns. The statement has already been made that there is no ideal pattern of capital structure for all corporations. For that reason it may be misleading to summarize the advantages and disadvantages of each of the

basic patterns. Nevertheless, such a summary is given here as a review of the principles discussed in this chapter.

One Class of Stock

Advantages

1. There are no fixed charges—interest on bonds—to endanger the existence of the corporation in bad times. With no interest, preferred dividends, or sinking fund requirements to meet, when lean times arrive the approach to the break-even point is retarded.

2. Directors have greatest freedom in setting dividend policies. When profits are high, they can distribute earnings without restriction; when they are low, they can reduce them or omit them. Dividend payments are apt to be more stable as well as more liberal.

3. It is easy to raise funds in the future. The company can sell whatever type of security is best suited to the market. If investors are not interested in common stock, it can choose between preferred stock and bonds; if they are demanding too high a dividend rate on preferred stock, it can sell bonds.

4. The corporation runs no risk of magnifying losses in bad periods through trading on the equity.

Disadvantages

1. It costs more to finance with common stock than with preferred stock or bonds.

2. By not trading on the equity the corporation loses the opportunity to obtain capital at a low rate, as well as the opportunity to increase profits in prosperous periods.

3. Raising capital exclusively by sale of common stock may entail dilution of control.

4. Absence of borrowed capital may reflect non-aggressiveness of management.

5. Investors who are looking for price appreciation and not merely dividend stability are not attracted by the conservative capital structure.

Common and Preferred Stock

Advantages

1. The market for the company's securities is broadened. Common stock, representing the residual claim to earnings or the speculative element in the enterprise may be taken by promoters and sold to investors ready to assume the risks involved. If the enterprise becomes successful, they reap the rewards. Preferred can be sold to more conservative investors and to institutions like trustees and insurance companies that are legally prohibited from investing in common stock.

Disadvantages

1. It usually costs more to finance with preferred stock than with bonds.

2. By not trading on the equity the corporation loses the opportunity to obtain capital at a low rate, as well as the opportunity to increase profits in prosperous periods.

3. Some of the restrictive provisions of the preferred stock may constitute a burden on the corporation and a restraint on the aggressiveness of management.

2. Control can be concentrated in one group, the common stockholders, by making the preferred non-voting.

3. The proceeds of the common stock form an equity behind the preferred, which cushions shrinkage in values of the non-speculative securities. The preferred stock therefore commands a better price when sold to the public.

4. The use of preferred stock, rather than bonds, leaves the company with a stronger balance sheet and hence greater leeway for future borrowing.

5. Without funded debt, there is not the risk of insolvency that is always inherent in fixed maturity obligations.

6. Management must watch operations closely in order that the company may be made to yield the last dollar that will go to the speculative security holders.

7. It costs less to finance with preferred stock than with common stock.

8. The corporation runs no risk of magnifying losses in bad periods through trading on the equity.

Stocks and Bonds

Advantages

1. It is usually cheaper to finance with bonds than with preferred or common stock.

2. The corporation profits through trading on the equity.

3. Taxes are reduced because interest on bonds is deductible for Federal income tax purposes whereas dividend payments are not.

4. Use of bonds avoids dilution of control.

Disadvantages

1. Rigidity of the contract restricts financial management. In bad times, management has the constant problem of meeting annual interest payments and principal at maturity. Default gives bondholders rights that may affect the management and even the life of the enterprise.

2. Unforeseen difficulties cannot be met easily, if the company is burdened with debt. An example is the railroad industry. When adverse effects of truck and pipeline competition became evident, the railroads could not help themselves because they were top-heavy with debt.

3. Losses are magnified through trading on the equity.

Fixing the provisions of preferred stock. A corporation that aims at gaining the advantages of a conservative capitalization will not issue preferred stock unless it expects to be able to pay the required dividend rate even in bad times. In working out its deal with the investment bankers, or whoever is to purchase the bulk of a new issue of preferred stock, management will include certain features to make the issue marketable. If market conditions require inclusion of speculative features, the preferred stock may have to be made convertible, or be issued with stock purchase warrants. For additional attraction, the holders of the preferred stock may have to be given the right to participate in earnings even though management feels that the participation feature is unfair to the common stockholders who bear the risk while waiting patiently for prosperity. The corporation may have to make the preferred stock cumulative although it realizes that the accumulation feature could, in bad times, result in troublesome arrearages of dividends. It might, however, provide that arrearages shall not begin to accumulate until some time after issue, that is, after the property obtained from the proceeds of the sale of the stock has had ample opportunity to get into operation.

Among the terms required to protect the preferred stockholders may be provisions restricting the amount of preferred stock that the corporation can have outstanding in the future. For example, a provision may state that additional preferred stock cannot be issued (1) unless the average annual net earnings for the three years preceding such issue shall amount to not less than three times the annual preferred dividend requirements after the proposed issue is made; and (2) unless the net current assets as defined shall equal the par value of the preferred stock outstanding after the proposed issue is made. Such a provision might limit the directors' freedom in future financing. Similarly, provisions relating to control of the corporation, that management does not desire, may be required when a new issue of preferred stock is created. For example, to keep exclusive voting power in the holders of common stock, management may make the preferred stock non-voting, but may have to give the stock vetoing or contingent voting power, as described at page 41. Such a provision might prove troublesome to the corporation in future financing of expansion. The difficulty of getting stockholders to attend meetings or to submit their proxies has already been described. If positive consent of large proportions of the preferred stockholders is required before the corporation can create new issues of bonds, refund existing issues, consolidate with other corporations, or consummate other important corporate financial action, management has the extra burden of persuading the stockholders to act in favor of its proposals.

Management will generally try to include the redemption feature in

preferred stock issues. The right to call in and retire preferred stock when earnings become large and stable can open the way to giving common stockholders the full enjoyment of earnings. Furthermore, with the redemption of the stock, any features that restricted management's freedom can be completely removed.[16]

Fixing the maturity date and terms of bond issues. A company borrowing for permanent capital needs usually prefers as long a maturity as possible. Generally, the following factors influence the maturity date: (1) Money market conditions when financing is undertaken. A company with perpetual funded indebtedness, a railroad or public utility, for example, would want a long delayed maturity date if it could borrow at a low rate, and a short term if interest rates were very high. (2) The type of security. An issue secured by a general mortgage on all of the corporation's property would have a longer term than an unsecured bond issue. In the late forties, however, low money rates and the general outlook for sustained prosperity tended to lengthen maturity dates even of debenture issues. (3) Technical reasons. An expiring franchise, wasting assets such as mines, the expiration of a contract for the supply of raw materials, and the like, may limit the maturity to a certain date. (4) What buyers will pay for different maturities. The longer the maturity, the higher the interest rate that is required. Generally, the issuing company must weigh the advantages of the longer maturity against the greater costs. The buyers, for reasons of their own, may not be induced to go beyond a certain maximum maturity no matter what the yield.

As in the case of preferred stock, the terms of the bond issue will be worked out with the investment bankers or other purchasers of the entire issue. Provisions that will help to make the issue marketable, like the conversion feature, or the addition of stock purchase warrants, and protective provisions such as limitations on further bonded indebtedness or on the payment of dividends, will be urged by the representatives of the buyers. Management will try to do everything it can to make the issue easy to live with. It will make the bonds redeemable, for example, in order that the corporation can rid itself entirely of the debt when that becomes possible and expedient. If the terms of the bond issue must be stiffer than it would like to have them, it will use the redemption feature to refund with another issue on more favorable terms when interest rates fall or when the company becomes stronger.

Surplus in relation to capitalization and capital structure. The surplus of a corporation must be taken into account in any study of capitalization and capital structure for it represents part of the owner-

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[16] See note 11 in Chapter 5.

ship interest in the organization. We shall discuss the creation and use of surplus more fully in the chapters on management of income and dividend and surplus policies. Here we merely want to point out that by plowing in surplus a corporation increases its capital investment and is able to make capital expenditures at a time when the securities markets are not favorable for equity financing.[17]

It is generally said that American concerns tend to expand out of earnings, while English concerns expand out of the proceeds of the sales of securities. We shall show in the chapter on expansion some of the objections to the practice of building up surplus for expansion purposes at the expense of dividend distributions.[18] Here we simply call attention to the fact that although financing expansion from the proceeds of the business is conservative, it frequently leads to unfair discrimination between owners of the business. In partnerships this point is hardly well taken, for the proprietors, in the expected course of business, are to remain the owners. But in corporations, especially in the larger concerns, change of ownership is the normal thing, and it seems only proper that each "generation" should "pay its way" and that each "generation" should realize its own profits.

Problems

1. The Norris Manufacturing Corporation has submitted the following balance sheet to its stockholders:

Cash	$112,943	Notes payable	$ 3,000
Securities	20,642	Accounts payable	50,422
Accounts receivable	45,094	Dividends payable	5,985
Inventories	103,246	Long-term debt	182,410
Investments	20,363	Capital stock	231,586
Building, land, equipment, net	418,046	Surplus	246,931
	$720,334		$720,334

(a) Determine the amount of capital both from the accountant's and the businessman's point of view.
(b) What is the capitalization?
(c) The capital structure?

2. Criticize the following proposed capital structure of a company engaged in the manufacture of jewelry.

Bonds	$2,700,000	2¾ %
Preferred stock	1,350,000	5% dividend
Common stock	4,050,000	
	$8,100,000	

[17] See Chapter 21, page 429.
[18] See page 429.

CHAPTER 10

Promotion

Promotion. Promotion is the first step in finance. It may be defined as the discovery of business opportunities and the subsequent organization of funds, property, and managerial ability into a business concern for the purpose of making profits therefrom. Promotions are generally of the following types:

1. A new kind of product or service is created. The discovery gives rise to a new enterprise or a new industry to exploit the profit possibilities in the field. Companies organized in the forties to produce prefabricated houses, frozen foods, and television sets were promotions of this type.

2. A new business is started in a field where there already are competitors. A promoter may undertake to launch an enterprise because he feels that other concerns in the line are making substantial profits. However, he must be reasonably sure that a new concern will be able to produce at a lower cost, for every new concern that enters a given field of production increases the available supply of products and thus tends to bring down the price of that product.

3. Several existing enterprises are brought together into one large unit. Here the promoter is actually seeking to reduce competition through the consolidation of several competing units. During the period of the formation of industrial trusts, say from 1880 to 1903, and during the period of the creation of large business units, say from 1915 to the end of the twenties, promoters found their largest profits in this form of promotion work.

4. An old established business, owned entirely or largely by a family group, is taken over by a new corporation, shares in which are sold to the public. The funds raised by the sale of the new corporation's stock furnish the cash necessary to buy out part or all of the interests

of the original owners.[1] Promoters may seek out the successful family-owned business that lends itself to this type of promotion, or the original owners, for reasons of their own, may take the initiative in bringing about the sale of family interests. Frequently, to convince investors that the new enterprise will be operated as efficiently as the old, the promoters must induce the existing management to enter into employment contracts with the new corporation for a definite period of time.

Types of promoters. Ideas for the creation of new enterprises of the types mentioned above emanate from the following types of promoters:

1. *Entrepreneurs.* Men who get ideas for creating a new business, bring that business into existence, and then carry on the work of the enterprise are entrepreneurs. In this class are the numerous small businessmen who start their own businesses. In the same group are officers and other business executives of established businesses whose very problems give rise to promotional ideas. For example, competition may suggest consolidation with other units; difficulties in obtaining material may suggest combining with a supplier or developing the raw materials through a separate enterprise; need for better distribution of a product or by-product may give birth to the idea of a new enterprise as an outlet. In modern business society, businessmen are the chief promoters.

2. *Investment bankers.* Ordinarily, investment bankers do not initiate enterprises. Their business usually is to investigate enterprises calling for funds and decide whether or not funds shall be invested in them. They are promoters, however, in the sense that frequently they initiate mergers. Also, they often promote the sale of rapidly growing, closely-held businesses to a new publicly financed corporation. The investment banker becomes active in these promotion fields when the securities market is able to absorb quickly new flotations of equity securities.

3. *Venture capital organizations.* In the late 1940's a new type of organization was created by a handful of wealthy individuals with the express purpose of "channeling equity capital into risk enterprise." Several such firms were established, among them J. H. Whitney & Co., Rockefeller Brothers, Inc., and Enterprise Development Corporation. Business propositions that need financing pour into these venture capital firms and are there screened. If they appear promising, the venture capital firm uses part of its capital in backing the new enterprise. For example, Minute Maid Corp., which sells frozen concentrated fruit juices, was backed by J. H. Whitney & Co. and proved one of its most profitable ventures.

[1] First public offerings by old established companies do not always indicate a sale of family interests. In some cases, the proceeds go into the company treasury to be used for expansion of facilities and for additional working capital.

Like investment bankers, the venture capital firms are more concerned with investigating enterprises and furnishing capital to those with merit and promise of success than in originating new ideas. However, they may be considered a type of promoter in that they enter into the picture in the early stages of promotion.

4. *Professional promoters.* The out-and-out promoter—a man like Charles R. Flint, who promoted the American Chicle Co., the United States Rubber Co., and a number of other companies—is a figure of another era, the late nineteenth century and the beginning of the twentieth. The professional promoter was characterized as an imaginative person, a good organizer, a man of means or one acquainted with men of means. He was able to visualize a successful enterprise growing out of an idea and knew how to assemble the elements that are necessary to give form to the idea. He was constantly on the lookout for new public demands and for means of satisfying them. He became known as a promoter, and people with money-making ideas, inventors, and others, were referred to him as one who would be able to determine whether an idea had commercial value and was worth exploiting. Such promoters did not interest themselves in managing the businesses they had promoted.

Although there are individuals today who have the qualities of the professional promoter, they rarely act as independent promoters. In the modern setup, professional promoters are more likely to be thought of as capitalists or individuals who are associated with venture capital organizations.

5. *Industrial engineers and lawyers.* Some firms of industrial engineers have become promoters as an outgrowth of the functions they perform in making investigations for other promoters. Lawyers, too, have sometimes become promoters through having been approached by people with ideas that can be exploited. Such promoters take no part in management after the enterprise is established.

Economic function of the promoter. The successful promoter makes large profits, so large indeed that it is sometimes thought that he is overpaid for the services he renders. The fact is that he not only takes huge risks but that he performs unusually valuable services for the public. In an action brought against Thomas F. Ryan by Harry Haskins, a promoter, the latter stated in his complaint that he had spent $50,000 in investigating the feasibility of consolidating a number of independent lead plants and in obtaining options on those plants.

An engineer's report on a projected electric light and power plant and distributing system may easily cost as much as $10,000 or more, and the result of the report may be to show that the project is not feasible. There is a well-known engineering firm in this country whose

specialty it is to investigate patents for new inventions to see whether the patents are secure against infringements and whether they are commercially exploitable. We are told that a fee of from \$10,000 to \$15,000 to ascertain the business value of an automobile accessory is not unusual. In another case a promoter spent \$30,000 for investigations, plans, and like material preliminary to the organization of an engine works. All such expenses are paid by the promoter, and if his investigations prove the inadvisability of such an undertaking—as they did in the case of the engine works—the entire cost is borne by him as a loss.

The promoter performs a public service whenever he produces a successful concern.[2] As we have seen, he either creates a new demand that helps us to do our business more readily, or to live more comfortably, or he supplies older utilities in a cheaper way, or he saves the ruining wastes of competition with its long trail of duplications, unnecessary advertising, and similar extravagances.

The promoter has been much maligned. He is not a prestidigitator. Rufus Wallingford no more represents the real type of promoter than Sherlock Holmes represents the true detective. The true promoter may have his moments of elegant ease, but he knows what real work is. As we shall see, the promoter's work of discovering, assembling, and financing is a matter of close attention to details.

Steps in promotion. The promoter accomplishes his purposes in three distinct steps: (1) he makes the discovery of the idea, (2) he assembles the elements of the business, and (3) he procures the funds to put these elements into operation.

Discovery, the first step in promotion. A promoter makes a discovery when he determines that an opportunity exists for exploitation. The opportunity is at this stage a mere idea that may involve the creation of a new demand or the satisfaction of an old demand that is not yet well or completely satisfied. Frequently, an idea is refined by subsequent promoters.

Discovery is essentially a matter of investigation. The idea itself may come as a flash to an inventor; it may be an inspiration on the part of some people engaged in a similar business to expand into a somewhat new field; or it may develop painfully in the minds of com-

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[2] This statement assumes, of course, that the concern brought into existence by the promoter's efforts does not abuse the interests of investors, of consumers, or of the general public. Unfortunately, the promotion of many large public utility holding companies and other combinations in the decade from 1920–1930 was marked by persistent and widespread disregard of public interest. This condition was revealed especially in the Congressional investigations which culminated in the passage of the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Act of 1935, and other regulatory acts. See Chapter 11.

petitors who see in it an escape from the ruin that a continuation of competition will entail. A familiar example of the last of these is the threat of Carnegie to go into the semi-finished steel products industry to forestall the plans of Morgan, who was taking steps preparatory to going into the iron ore industry. But the feasibility of the idea must be investigated by a person whose training and experience fit him to weigh impartially all the elements of advantage and risk that lurk in a projected enterprise. In the very nature of things, a person who has conceived an idea usually is an optimist and an enthusiast; his viewpoint is warped by prejudice. It would be much better for him to turn over his idea to an impartial investigator who can weigh the elements that will have to be taken into consideration in making a fair forecast as to whether the enterprise will be profit-making or not. It will be seen, therefore, that the mere conception of an idea is not all there is to discovery. This step in promotion includes not only conception but investigation.

Investigation also has three steps: (1) making a rough estimate; (2) making a detailed investigation; and (3) checking up or verifying. Each of these steps will now be explained.

Making a rough estimate. An idea may be brought to a promoter who is asked to develop it into a business enterprise. He will first inquire who originated the proposition, and in obtaining the answer to this question he may save much unnecessary labor later. The unlikelihood of a feasible idea coming from an incompetent person is so great that the first rule of the promoter is that a proposition must be properly sponsored. An example of good sponsoring could be found in the case of a bright young man who has had experience in the line of business and sees improved methods that do not appeal to his old-fogey employers.

The promoter will then seek to determine the basic idea in this business. Is it a manufacturing or a marketing idea? Does it satisfy an old want in a new way, or does it depend upon the stimulation of a new demand? The promoter, it will be seen, should be a man of wide experience who can sense the possible value of new ideas and reject without laborious investigation those that are palpably defective. The aim in making a rough estimate is to determine whether it will pay to spend the time and money necessary to make a detailed investigation.

Making the detailed investigation. At this stage of his inquiry the promoter will have no more than a "hunch" that he is on the track of a profitable idea; but it will not pay him to spend his time or to risk other people's money in testing out in actual operation the value of a "hunch." He must make, or cause to be made, a detailed investiga-

tion. The cost of this investigation is comparable to an insurance premium. It costs money, to be sure, but it is a protection against a much larger loss.

If the enterprise is one that involves difficult production problems, investigation will be carried on chiefly by an engineer. If it depends for its success upon the possible existence of a demand and the discovery of a proper method of reaching that demand, the services of a marketing analyst should be secured. If, on the other hand, the promotion is in the nature of a consolidation, the investigation will be carried on chiefly by accountants and appraisers whose business it is to determine the values of the constituents of consolidation. Additional specialists may be required, such as chemists, patent-lawyers, and others.

Scope of detailed investigation. The analysis of a projected new enterprise,[3] from the standpoint of the promoter, involves (1) an estimate of earnings, and (2) an estimate of financial requirements.

Methods of estimating earnings. The problem of estimating probable earnings may be divided into two parts: the estimate of gross revenue or sales, and the calculation of the operating costs. Three methods are generally used in estimating gross revenue and operating costs. These methods are (1) the statistical method, (2) the canvassing method, and (3) the comparison method.

Statistical method. In the statistical method, the various elements to be estimated are broken up as far as possible into uniform units and the cost of each unit is estimated; for example, how many employees will be needed and at what salary they will be employed. After the number of units and the cost of each is known, it is simply a matter of mathematics to arrive at the total cost. A study of available statistical data, such as bank deposits, life insurance sales, automobile registrations, and the like, will indicate the spending potential of a community. From these figures the promoter can estimate volume with considerable precision.

Canvassing method. In the canvassing method, abstract units are not used. Actual estimates are made of the cost of building the proposod plant. The promoter makes a visit to the area to be served by the product of the projected business to examine—that is, to "canvass"—the area. The purpose of the canvass is to review the potential market for the products of the company and to inspect possible sites for the location of the plant. The review of the potential market involves an analysis of existing competitive companies in the area to be served, sources of supply, pricing history, and other important fac-

[3] We shall not consider here the promotion of consolidations. This subject is treated in Chapter 23.

tors. It entails getting the opinion of important businessmen about the project and, also, sounding out potential buyers. In some cases definite contracts from a limited number of customers may be secured, thus assuring the minimum volume of business required to meet a minimum expense budget.

Comparison method. This method involves studies of companies that do work similar to that of the projected company and that are of about the same size. The studies cover the cost and operating data of the selected companies, their general business and financial characteristics, their technological development, and their balance sheets and income statements. Certain errors may creep into the investigation when this method is employed. First, an analysis of a single concern may be misleading. Promoters of magazines, for example, may point to the wonderful success of *Life,* but overlook the hundreds of failures that did not have a Henry Luce to guide them. Second, the selected enterprises may have been developed under different conditions. For example, it would not be fair to state that a projected airport can be built for $1 a square foot because an airport had been built for that amount. The condition of the ground, the surrounding obstructions, and the like, may be entirely different from those at the airport that was constructed at the low figure. Third, instead of finding the average costs and the average operating results of a number of concerns, the investigator may erroneously use different individual concerns for comparison purposes at various stages of the calculations.

An investigator will not necessarily follow throughout his investigation one of these three methods in making his studies of probable income and outgo and the economic justification of the project. He will perhaps use the statistical method for estimating some of the costs, such as the promotion expenses; the canvassing method for estimating the costs of constructing operating properties or of acquiring fixed assets; and the comparison method for estimating the gross revenues and the operating expenses. In fact, a combination of methods may be used for any phase of the investigation.

Estimating financial requirements. Determining the amount of funds required to start the projected enterprise is an important part of the investigation. The estimate is made after the probable volume of sales and operating costs have been determined as precisely as possible. The purposes for which funds for the new business will be needed may be classified as follows:

1. Promotion expenses.
    a. Preliminary investigation of the project.
    b. Assembling parties who may be willing to participate.
    c. Preliminary engineering, legal, accounting, and marketing advice.

   d. Estimates of costs, income, and expenses.
   e. Procuring options.
2. Organization expenses.
   a. Incorporation of the company.
   b. Expenses of keeping the corporate organization going until the company begins operations.
   c. Taxes and interest due before the company begins operations.
   d. Miscellaneous legal and accounting expenses.
3. Cost of fixed assets.
4. Cost of establishing the business, which covers all expenses, including canvassing and advertising for business from the time the company begins operations until its income is sufficient to meet expenses.
5. Working capital requirements.
6. Financing, including banker's commissions, costs of preparing and filing registration statements under the Securities Act of 1933, if there is to be a public offering of securities in more than one state, and promoter's compensation. Under conservative accounting practices, organization and promotion expenses do not appear on the balance sheet as an asset. However, these expenses and losses represent an investment of capital and the investor is entitled to a fair return on the investment. In public utility industries, where return on investment is regulated by the Government, these intangible investments have developed the concept of an intangible asset known as "going concern value."

Importance of covering each purpose for which funds are needed. This classification may seem to be extraordinarily detailed and applicable only to large enterprises. The fact is that it is important in the smallest as well as in the largest projects. Some of the items, to be sure, may be very small, but this is likely to be true only *absolutely* and not *relatively*. At any rate, the promoter entering upon any project will do well to use a table like that contained in the foregoing paragraph, no matter what undertaking he has in hand, for then he will be less likely to fall into the grave error of making his estimates too low. This, after all, is the great danger against which the promoter must guard. There is a fundamental rule of finance that the last dollar is always the most valuable dollar. If $100,000 has been invested in a concern and $10,000 more is needed, the people who furnish the final $10,000 are likely to demand as large an interest for their money as those who furnish the first $100,000. Without the last $10,000, the first $100,000 will become worthless. The promoter then must see to it that his estimates are ample and that no money is tied up till the full amount is in sight.

Promotion expenses. All the promotion expenses can be reduced to a matter of paying the promoter and his engineering, accounting, and marketing experts for the time required to make their investigations. The promoter may be paid a flat fee, but he is usually given a percentage of the common stock.[4] The percentage may range from 10 to 51 per cent, depending upon whether the promoter serves merely in an advisory capacity or functions as inventor, promoter, and banker. Some money probably will have to be given in a lump sum to bind the options, such as an option on a patent, but frequently even the consideration for the options will be the promoter's promise to undertake and prosecute the promotion of the company. The actual outlay for promotional expenses should always be kept in proportion to the size of the venture.

Organization expenses.[5] The term *organization expenses* is applied to the expenses incurred in legally forming and incorporating the company, such as lawyers' fees, filing fees, and organization or incorporating fees, which vary with the capitalization. Clerical help and office expenses during the organization period should also be included in the calculation of these expenses. Organization expenses can be calculated with precision once the capitalization of the company has been determined.

Cost of fixed assets. In estimating the fixed asset requirements, the projector must determine whether or not the product is to be marketed only, or is to be manufactured as well as marketed. Promoters and management of a new business that finds difficulty in raising funds should make every effort to minimize fixed assets. Some very prosperous concerns have been built up on products produced outside the business itself. Such concerns, for example, are the mail-order houses.

The options that are open to a projector are more numerous than is generally suspected. (1) The concern may do its own manufacturing with its own machinery, either (*a*) buying the plant or (*b*) leasing it. This method of conducting the business gives the concern the manufacturing as well as the selling profit, insures uniformity in quality and quantity of output, and holds out the possibility of meeting competition through reduction of manufacturing costs. On the other hand, profits may be cut down through such contingencies as strikes and fluctuations in costs of material; the manufacturing effort may be great compared with the selling effort, while the profits from the former may be relatively small and the time and effort required to get the manufacturing started may preclude large profits that could be obtained

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[4] See pages 207 to 208 for payment of promoters with stock and stock options.

[5] These expenses run from the time an office is engaged until the company is organized, the funds are raised, and the company begins operations.

by getting to the market immediately. (2) The concern may contract to have its product manufactured for it, (*a*) owning none of the machinery, or (*b*) owning the patterns and special tools. The arguments for and against this plan are about the reverse of what they were for Plan 1. (3) The concern may contract for the manufacture of its product but may itself buy most of the raw material, thus saving the buying commission. Moreover, this plan insures steadiness of output in times when materials are scarce. (4) The concern may assemble its product, and may (*a*) make none of the parts, or (*b*) make some of the parts. Many automobile concerns use outside parts almost exclusively and probably few, if any, of the manufacturers in this country make the entire automobile. The problem here hinges on large-scale production. One concern, for example, may not require enough axles to enable it to produce them in large quantities and thus get the benefits of large-scale production.

The reader can easily determine for himself, with but little consideration, which of the methods of operating a concern will require the greatest amount of initial capital.

In estimating fixed asset requirements, the extreme of inadequacy as well as the extreme of overinvestment should be avoided. In some industries, there is a need for initial excess capacity. For example, public service industries must acquire facilities in excess of the demand anticipated in the early stages of development, because enlarging the facilities piecemeal is too expensive. On the other hand, some businesses, such as chain stores, can add to their investment by piecemeal as sales expand.

Cost of establishing the business. The operating losses that will be incurred until the business is self-supporting must also be included in the estimate of financial requirements. The market expert's analysis of the feasability of the enterprise will probably include a plan for marketing with estimated costs, and an estimate of the time it will take to bring cash income up to cash outgo. The operating losses have special significance in types of businesses that require a prolonged period in which to become self-supporting. For example, considerable time is required to familiarize the market with the merits of a novel product.

Working capital requirements. Although the cash raised to purchase fixed assets is a "current asset," a business needs cash over and above that amount in order to function. A business must have cash or its equivalent that is available for "working capital"—current capital over and above the amount required to meet current liabilities—and that remains more or less permanently available for that purpose. A business usually requires more working capital initially than after

the cycle of production, selling, and collection is once completed. The problem of the promoter is to discover how much funds the company ought to have at the outset beyond the amount required to establish the business. Some margin of liquid capital will be required for contingencies and to give the company a good credit standing. Working capital is discussed from every standpoint in Chapters 15 and 16.

Cost of financing. Thus far we have considered financial requirements for promotion expenses, organization expenses, fixed assets, establishing the business, and working capital. Cash must be raised to meet these requirements, and the cost of raising the cash is an additional expense. If the required amount is small, the promoter may undertake to raise it himself, possibly paying commissions to intermediaries. If the required amount is large, the promoter will engage the services of an investment banker to raise cash or sell securities. The cost of flotation, which may be very substantial, must be met before the funds are available. If the securities offered to the public exceed $300,000, there is the additional expense of preparing a registration statement and prospectus to meet the requirements of the Securities Act of 1933, unless the securities are sold only to residents of the state in which the corporation is organized and does business.[6] In the latter event the issue is exempt from the Act.

When the amount of capital needed, including the cost of raising it, is determined, that amount is tested against estimates of earning power to determine whether the rate of return is adequate to support such a capitalization. For example, those who are asked to put up the money might be willing to do so if estimated earnings showed a return of 10 per cent on the amount invested. If the suppliers of the capital looked for a better rate of return, the enterprise might never come into existence. On the other hand, if 10 per cent was more than investors were requiring from this type of venture, the capitalization might be made higher than the actual capital needs.

Special cases of investigation. Since many enterprises are similar in that they center about some central idea such as a patent, or a peculiar piece of property, for example, a mine or a timber tract, we may consider briefly the principles involved in investigating these common types of promotion.

Investigation of inventions. The investigation of inventions may be entrusted to capable and experienced engineers and patent attorneys, but there are a few simple principles that every promoter should understand. The risks are enormous.

Whether the invention is patented or not these questions should be asked:

[6] See Chapter 12 for costs of raising capital through public issues of securities.

1. Is the device worthwhile? The records of the patent office are crammed with applications for silly devices, such as a bed that will eject the lazy sleeper, a device for keeping the feet warm by conveying to them breath exhaled from the lungs, and the like.[7]

2. Is the idea practicable? In the chemical business, for example, a laboratory reaction may be obtainable, though the production of the same result on a commercially large scale may not be attainable.

3. Will the device accomplish the purpose for which it is designed? We are reminded of the patent obtained on the idea of preventing fraud in the sale of cigars. The fraud consisted in putting high class bands on plebeian tobacco, and the remedy was to weave into the high grade cigar a silk thread. The claim was made by the deluded inventor that while the defrauders might substitute bands, they would not dare infringe the patent of weaving a silk thread.

4. Is the device marketable? Safety razors, toilet preparations, and the like are hard to sell, however meritorious.

5. Have licenses or similar interests been granted in such a way as to nullify the value of the patent to the patentee or owner, and hence to the corporation to which he is planning to convey the patent?

If the patent has been obtained, these questions may be asked about it:

1. Is the patent good, in the sense that its claims have not been anticipated?

2. Are the claims broad enough? A German doctor obtained a patent on the solution of a certain East Indian gum in turpentine. Along came a chemist who patented the solution of the gum in any hydrocarbon other than turpentine.

3. How old is the patent? The life of a patent is only 17 years.

Secret processes are difficult to investigate. It can hardly be expected that the inventor will divulge his process, and reliance must therefore be placed upon his integrity in his statement of costs.

Investigation of timber tract. Another example of the hazards that must be run in connection with a seemingly simple proposition is the timber tract. It would seem that practically no risks are run by the man who puts up money to place a mill on a timber tract and pays for cutting and transporting the lumber. However, there is first the question of title. Vast tracts of virgin forests in Tennessee, Kentucky, and Virginia have not been worked because it is almost impossible to get a clear title. Then there is the problem of fire risk. What is a fine stand of timber today may be a charred desert tomorrow. There is also the problem of getting the timber out. The mountain sides may

[7] It must not be assumed, from what is said here, that patents are always valueless. Many a large industry of this country has been built up entirely on patent rights.

be steep and the streams practically useless. Moreover, the difficulty of getting a reliable "cruise" or estimate may result in gross overestimates of value.

Need for checking up the investigation. The investigation is, as we pointed out, made by an independent expert, perhaps an engineer or a marketing analyst. In any event, the investigators are supposed to be competent and impartial. However, too much reliance must not be placed on their impartiality and integrity. Frequently, an incompetent investigator is chosen because the promoter can afford to pay for his services while the services of a reputable investigator would be beyond his means. Sometimes the investigator is partial because he has an interest in the subject of the investigation. For example, promoters have frequently chosen state geologists to make a report on a proposed cement plant. The state geologist is interested in attracting industry to the state; that in effect explains "the reason for being" of his office. While the prestige of his office is likely to be accepted as a point in his favor, it should, in fact, be a cause for suspicion. Then, too, there is the question of fees. The promoter is eager to have a favorable report; the investigator knows that. And because the fee is to be paid by the promoter and because the promoter, if successful in launching this enterprise with other people's money, is likely to have other projects on which he will need reports, the investigator is likely to resolve doubts favorably to the project. Moreover, the investigator will probably meet the promoter frequently and may become infected with the latter's enthusiasm.

Checking up is all the more important because there is an insidious guarantee of accuracy in an array of figures. The number of facts included may be complete, the conclusions from those facts may be inevitable, and still there may be the simple fault of inaccurate facts.

The civil and criminal liabilities placed upon issuers of securities and others for material misrepresentation of facts in registration statements and prospectuses filed under the Securities Act of 1933 make it extremely necessary for the promoter to have his investigation carefully checked before he undertakes to raise capital through public offerings.

The report evidently must be checked by somebody who represents the capitalists' interests rather than the promoter's interests. This somebody is likely to be the statistician of the financial institution to whom application is made by the promoter for the funds indicated by the report to be required for launching the project. Whoever it is that represents the sought-for capital, he must be a man of clear judgment, careful and diligent, and experienced in examining reports.

Methods of checking up investigation. There are three practical methods of checking up an investigation: (1) examining the report, (2) checking by comparison, and (3) checking up by trial.

Examining the report. The purpose of the examination is to see whether it contains errors in mathematics, omissions, or false reasoning. A common omission is an allowance for contingencies. In many of the promotions of the post-war period, the new enterprises ran into difficulties because of inadequate provision for the contingency of higher prices. Lustron Corporation, for example, planned to produce a prefabricated steel house that would sell for $7,000. The post-war inflation increased the cost of the company's plant and equipment about five million dollars. As a result, the house produced had to sell for $9,000. Unforeseen difficulties arose in marketing and financing the sale of the homes. Also, inexperience in the field proved costly. Federal loans of $37,500,000 were not enough to stabilize the company's finances. "There have been too many inadequate starts, too much inadequate capitalization in the prefab field," Carl G. Lustrand, president of the company, is quoted as saying. "A lot of these people failed because there had been no bolster for weaknesses ahead." [8]

Checking by comparison. This method consists simply in comparing the results of one method of investigation with the results obtained by another method. Thus, if by using the so-called statistical method of investigation it was found that $40,000 was needed, some assurance of the accuracy or worthlessness of the details could be obtained by comparing that sum with the investment in similar concerns. In checking up by comparison, the chief object is to find a unit for the basis of comparison. In estimating capital costs, the unit is usually the unit of capacity, such as the kilowatt capacity of an electric power plant, the miles of track of a railway, the net tons of a ship, the barrel capacity of a cement plant or an oil refinery, and the spindle capacity of a cotton mill. In checking up costs of operation, the unit of comparison is usually the cost per unit of product or actual production. Thus, the operating costs of two cement plants can be compared on the basis of the cost per barrel of output.

Checking up by trial. Where marketing costs are an important factor in the success of an enterprise, estimates are likely to be quite at variance with the results. In other words, the margin of error is likely to be large. The best way to reduce a possible loss to the minimum is to check up estimates by making trials. For example, if it is planned to form a company to market a new trade-marked brand of coffee, instead of carrying out a campaign throughout the entire country, a test may be made in one community. The factor of error in calculating, which is revealed by an actual attempt to market the new brand in that community, may be assumed for the country as a whole.

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[8] *Architectural Forum,* May 1949.

Assembling the elements—the second step in promotion. After a discovery has been made and it has been decided to go ahead, the elements of the business must be brought together. The important elements from the standpoint of financial plans are: (1) the idea; (2) property necessary; and (3) managerial ability. Funds, of course, are necessary, but the problem of raising them is considered under the third step in promotion, that of financing.

Protecting the fundamental idea. If the idea to be exploited centers upon an invention, it can be protected by patenting the invention. If the idea involves use of written matter, it can be safeguarded by copyrighting the material. If the use of a trade name, trade-mark, or slogan is the substance of the idea, some protection is afforded through registering the trade name, trade-mark, or slogan with the Patent Office.

But the basic idea may have no device or property attached to it. It may be the discovery of some demand that is not being filled, or it may be a better way of filling a demand, or a method of reducing costs by consolidation of existing plants. How can this "idea" be contributed and the value of it protected? An idea is not patentable; only the device for carrying out an idea can be patented. Neither can an idea be copyrighted. The person who originated "Bank Night" as a way to attract people to moving picture theaters found himself without protection when he sued a theater owner for using the idea. The originator of the idea had copyrighted his advertising matter and the material explaining the system, but since these had not been reproduced, there was no basis for complaint. The system of operating "Bank Night" could not be protected.

Only two methods are open for protecting "ideas" against piracy. One is to present the idea only to promoters who are known definitely not to be pirates. The other is to protect it by contract. The difficulty of drawing a binding agreement is almost insuperable. How can the discoverer of such an idea, for example, as the building of a gas plant at such and such a place, prevent anybody else from building at that place? The fact is that the person who discovers the idea usually tries to protect himself, and does so to a certain extent by doing a part of the assembling himself. For example, he may obtain the special franchise to build the gas plant and in that way practically prevent others from coming in. But even in such a case the special franchise may be rendered almost useless by non-user.

The case of Harry Haskins against Thomas F. Ryan is well known and interesting.[9] Haskins conceived the idea of consolidating a number of independent lead companies and procured options on their

[9] 71 N.J. Eq. 575, 64 Atl. 436 (1906), affd. 75 N.J. Eq. 623, 73 Atl. 1118 (1909).

plants. These he took, so he alleged, to Thomas F. Ryan, who professed an interest in taking up the options. Instead of taking up the options, Ryan, so the story goes, on one pretext or another delayed the consummation of the plan till the options expired, and then went about the consolidation himself. In a word, Haskins was "frozen out."

Methods of taking property. Control of the essential property connected with an idea, whether the property be a patent or secret process, a special franchise, or the plants of the constituents of a consolidation, may be acquired in one of several ways. (1) The promoter may take title in his own name. (2) Title may be taken in the name of a small corporation to be expanded later or from which title may be taken by the final corporation. This apparently was the method used in the promotion of the United States Steel Corporation. (3) The title to the property may be placed in the hands of a trustee to be turned over by him to a corporation upon the performance of certain conditions, such as the payment of certain sums of money for the use of the company that is being promoted. (4) The promoter may procure an option, which, if not taken up, will entail only the loss of the money necessary to bind the option. To be sure, the loss may be considerable, since the persons originally owning the property may be unwilling to give binding options unless a large sum is paid. It is said that Henry Frick lost one million dollars when he failed to get the necessary funds to take up his option on Carnegie's plants a year or so before the formation of the United States Steel Corporation. (5) The promoter may make a contract to buy. If the contract is not put through, the promoter will have to stand ready to pay damages for breach of contract.

Assembling managerial ability. The importance of managerial ability is generally too well understood to be dwelt upon here. The promoter should not be successful in his quest for funds for a new company unless he can show that he has available the kind of managerial ability necessary to success. Losing sight of the management element, from either the standpoint of production or of marketing, can quickly cause the failure of a new enterprise that otherwise would have been successful. Securing managerial ability, however, is generally a matter of paying the right price.

Presenting the proposition. When an idea has been conceived, investigated, and checked, and when the necessary assembling has been made, the promoter has what is popularly called a "proposition." His next step is the financing of the proposition. However this is done, the previous work will have to be organized for presentation to the prospective capitalists. A careful promoter will keep a file of all papers and correspondence connected with the discovery and assembling. These will be available to the capitalists in checking up the accuracy

of statements made by the promoter in his formal presentation. The presentation should be a well-organized, clear, concise statement of the proposition, supported by copies of engineers' and accountants' reports, lawyers' opinions, copies of legal documents, copies of government reports, pamphlets, and material relied upon to show the value of the plan. It should be neatly arranged to convey in its physical appearance some degree of the care exercised in making the discovery and accomplishing the assembling.

Financing—the third step in promotion. The cost of financing the promotion up to the point where the final proposition is presented to the capitalists should be borne by the promoter himself. If the project fails to mature into a promoted concern, the promoter will be out of pocket; if the financing is successful, he will reimburse himself from the contributions of the participants to whom interests in the business are sold. Financing means the actual acquiring of funds with which to procure the necessary property, tangible and intangible, and with which to perfect the organization, start operations, and keep them going until the business is on a self-supporting basis.

The promoters may have connections with investment bankers and other capitalists, and may be able to arrange for the financing of the new enterprise. If so, the financial plan will be worked out, the corporation will be organized, and the securities will be sold to or through the financiers. We are not concerned here with the sale of securities; that subject will be discussed in Chapters 12 and 13. If the project is inherently so small or of such a nature that the usual channels for raising money cannot be used, or cannot be used profitably, and if the promoters have not the necessary financial connections, the limited sources of funds ordinarily available to small business may have to be tapped.

Financing small new businesses. Most small businesses need outside capital in amounts of less than $100,000. According to the best information available, the large reputable investment houses find that an issue of less than $1,000,000 is unprofitable. A number of security houses in the smaller cities, however, handle issues in amounts of a few hundred thousand dollars up to a million dollars on a commission basis.

If the enterprise in which the promoter is interested is located in an area where a community lending agency has been established for the purpose of helping new small enterprises raise funds, the promoter may try this source. One such institution is the New England Industrial Development Corporation, sponsored by the Filene interests of Boston. Similar community lending agencies have been set up in other communities, including Baltimore, Maryland; Wilkes-Barre, Pennsylvania; and Louisville, Kentucky. Or the promoter may attempt to in-

bility to pay for these services unless it consents to do so. Obviously this rule, though technically correct, has no relationship to reality. The promoter performs a necessary function in assembling the corporation, and those services are valuable; without them, there might be no corporation. In most instances, of course, the corporation agrees to compensate the promoters for their services. Compensation may take one or more of several forms: (1) cash reimbursement for expenses actually incurred, (2) stock in the new corporation, and (3) option warrants to purchase additional stock.

Payment of promoters with stock. In many organizations and reorganizations, the procedure is to sell preferred stock to the public to pay for whatever assets are purchased by the new company, and to turn over to the promoters, organizers, reorganizers, and bankers, as compensation for their services in promoting the company, blocks of common stock. Sometimes a small portion of the common stock is given as a bonus to the purchasers of preferred shares. If the company is successful, the profits of the promoters will be large; if the company fails, the capital contributed by the preferred shareholders will be at stake. The plan of giving shares of preferred stock that have a prior claim to assets to those who contribute the capital, and of issuing common stock to the promoters, prevents impairment of the capital contributed by the preferred stockholders through claims of those who have received their shares as compensation for promotion services. In many instances, however, this plan is not followed. Only one class of stock is provided for, part of which is given to the promoters as compensation and part sold to supply the corporation with needed capital.

Although technically the arrangement under which promoters receive their compensation in stock may meet all legal requirements, there may be instances where the arrangement would be unfair to incoming stockholders. In such cases, unless the persons concerned have consented to the arrangement, they may complain of the transaction and obtain aid of the courts in dealing with the offenders.

Payment of promoters with options to purchase stock. Payment of promoters with options to purchase stock has become a common method of compensation. The corporation authorizes the issuance to the organizers of an option or right to purchase shares of stock at a stated price, generally within a fixed future period. Thus, without immediate expenditure, the option holders acquire an opportunity to make a substantial profit in the future in the event that the corporation is successful. The option, of course, will not be exercised unless the price of the stock exceeds the price fixed in the instrument. As in the case of stock given as compensation for services rendered by promoters, the giving of an option is a valid means of compensating pro-

moters, provided the transaction is fair and not unreasonable and oppressive.[11]

Disclosure of options granted is necessary in the case of securities which must be registered under the Securities Act of 1933. Both the registration statement and the required prospectus call for a statement of the securities covered by options outstanding or to be created in connection with the issue covered by the registration. The statement must show the price and other terms on which the options are granted, as well as other information, including the names and addresses of all persons to be allotted more than 10 per cent of any set of options.

Prior to the enactment of the Securities Act of 1933, disclosure of the issuance of options was within the discretion of the issuing corporation. In some instances, the option that had been given was disclosed in the certificate of incorporation or in the circular issued upon the sale of stock in the corporation, or in both places; in other cases the option was not disclosed. This situation still exists where the public issue of securities is exempt from registration because it does not exceed $300,000, or because the channels of interstate commerce are not being used in its distribution.

Right of officers to compensation for promotion of subsidiary companies. Officers of a corporation will sometimes promote a subsidiary company that is neither entirely a subsidiary nor entirely independent of the parent company, and will take in compensation for their services as promoters stock of the newly formed company. In many cases where such corporations are formed, the new company becomes engaged in a business collateral to the activities of the principal corporation, and the capital is obtained from stockholders in the existing corporation. In other words, the officers of the existing corporation take advantage of the strength of the corporation and of the opportunity to obtain capital from its stockholders to promote the new company. There may be some question in such cases as to the right of the officers to profit in this way by their position as officers in the principal corporation. The rule has long been established that where a corporation has an opportunity for a profitable transaction, it is the duty of the officers to exploit such an opportunity for the benefit of the corporation, and if they profit directly or indirectly where the corporation should have profited, they may be required to account for the profits thus obtained.

The Securities Act of 1933, the Securities Exchange Act of 1934, and the Public Utility Holding Company Act of 1935 contain pro-

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[11] What is reasonable is always a question for a court of equity to decide.

visions which make it difficult for officers of subject corporations to profit by their positions in the manner described above.[12] A full and complete disclosure of the officers' compensation as promoters would be required in the registration of the securities of the new company under the Securities Act of 1933. Such disclosure, the officers may realize, would discourage the purchase of the securities by the existing stockholders.

If the parent company were a public utility holding company, subject to the Public Utility Holding Company Act of 1935, and the subsidiary were a public utility, the acquisition of the subsidiary's stock by the officers could not be effected without the approval of the Securities and Exchange Commission. Even if the subsidiary were not a public utility, the transaction could not be effected without a disclosure of the issuance of stock to the officers of the parent company for services. Such disclosure would appear in the forms required to be filed under the Utility Act with the Securities and Exchange Commission in connection with the issuance of the subsidiary company's stock. Furthermore, the Commission has interpreted the Act so as to impose standards which proceed far beyond the principle of disclosure. Thus, one of the objectives of the Commission is to eliminate profits arising from failure to recognize fiduciary responsibilities.

Legal aspects of promotion. Although this is not a book on law, there are some legal questions connected with promotion that every promoter should know. They affect to such an extent the work that the promoter does, that expertness in promotion cannot be achieved without knowing something about them. The promoter must understand his relationship to the corporation and to other promoters who are associated with him. He must know what his liability is on agreements made prior to incorporation and for expenses incurred in bringing the corporation into existence. Also, he must understand the limitations that the law places on his right to make a profit out of the promotion. The directors and officers of the newly created corporation also are interested in these legal questions and in addition are concerned about the liability of the corporation for contracts made by the promoter. The following paragraphs throw light on these important legal questions.

Relationship of the promoter to the corporation. Anybody who undertakes to organize or to assist in the organization of a corporation

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12 Both the Securities Exchange Act of 1934 and the Public Utility Holding Company Act of 1935 contain a provision which permits recovery of any profits realized by officers and directors of companies subject to the Acts from transactions in securities of such companies within a period of six months, unless the securities were acquired in good faith in connection with a debt previously contracted.

or other association is a promoter.[13] A promoter occupies a fiduciary relationship—a relationship of trust and confidence—toward the corporation he promotes and the utmost good faith is required of him in his dealings with it. He is required, in his dealings with the corporation while he is a promoter, to protect the interests of the company and its future stockholders. The fiduciary relation of a promoter extends from the time he begins to promote until the time he ceases to be a promoter. Thus, while he is a promoter he cannot take advantage of his trust position to make a secret profit for himself. It is essential, then, to know when a promoter begins to promote and when he ceases to promote.

When does a promoter begin to promote? The following illustration shows the importance of this question: A man owns a piece of property and has held it for a long time. He promotes a corporation to take over the property. At what price must he yield it to the company? The property may have appreciated year by year and he is entitled to no profit through his holding that may accrue during the time of promotion. On the other hand, he is not bound to turn it over to the company at the very small price he may have paid for it when he first bought it. The answer is that he must give it to the company at what it was worth at the time he became the promoter, and this time is fixed as the moment he conceived the idea of promotion. Since it is hard to read men's minds, a more practical rule is that the promoter begins to promote when he first does something in connection with that operation.

When does a promoter cease to promote? A person who has ceased to act as a promoter may deal with the company "at arm's length" and may make a profit from his transactions as may any other third person. Ordinarily a person ceases to be a promoter when the corporation is fully formed—that is, when the real stockholders in interest have elected a permanent and independent board of directors which undertakes the management of the corporation. At that time the promoter may say to the permanent directors, "If you care to buy this property, I'll sell it at such a price," and the bargain, in the absence of any misrepresentations, will be binding on the company.

Relationship of promoters among themselves. Frequently several individuals are associated in promoting a new corporation. The relationship they bear to each other may be that of partners, joint adven-

[13] This definition is recognized in court decisions dealing with registration of securities under the Securities Act of 1933, forms for which call for certain disclosures with regard to promoters. The regulations issued by the Securities and Exchange Commission expand the definition of a promoter to include any person who, in consideration of services or property, has received, or is to receive, 10 per cent or more of any class of securities of the company or 10 per cent or more of the proceeds from the sale of any class of securities.

turers, or principal and agent, depending upon the contractual relationships expressly or impliedly assumed toward each other. One promoter may enforce a contract against another promoter. A promoter who has paid all or part of the costs of promoting a projected organization is entitled to contribution from such of the co-promoters as were also liable for the expenses incurred.

Promoters' agreements. We have seen in connection with the assembling of a proposition that various contracts are made for acquisition of property and for engaging the services of employees of one grade or another. All such agreements made prior to incorporation may be termed promoters' agreements. The general rules applicable to the law of contracts are *not* fully applicable to promoters' agreements, for the promoter's position is different from that of an ordinary party to a contract. A promoter enters into contracts in behalf of a proposed corporation. Since the corporation is not yet in existence, the promoter cannot be an agent of the corporation and cannot bind the corporation by his acts. Hence, those who contract with the promoter do not ordinarily expect him to perform the contract, but expect that the corporation, after it comes into existence, will make the contract its own.

Adoption of promoter's contracts. Sometimes the promoter's agreements are made with trustees for the corporation. At other times they are made in the name of the corporation. In any event, they are not binding on the corporation until the corporation knows all about them and adopts them. The adoption of the contract need not be by express action of the corporation, but may be inferred from the acts of the corporation or its agents. The corporation cannot be said to adopt any contract the terms of which it does not know fully. It is improper, therefore, for a promoter to turn property over to a corporation, stating that he is to make a profit on it or that the corporation's directors can find out how much the profit will be by consulting certain deeds.

Promoter's secret profits. As already indicated, a promoter may not make a secret profit for himself. A promoter's profit is not secret or unlawful under the following circumstances: (1) if he makes a full disclosure of all material facts to each original subscriber of shares in the corporation; (2) if he procures a ratification of a contract, after disclosing its circumstances, by vote of the stockholders of the completely established corporation; (3) if he himself is the real subscriber to all the shares of the capital stock contemplated as a part of the promotion scheme.

The Federal securities acts contain no specific provision making promoters liable to the corporation for secret profits, but some measure of control over promoters' profits is possible through the right of the Securities and Exchange Commission to compel disclosure within

reasonable limits. When the directors of a newly created corporation learn that the promoter made secret profits during the period of promotion, they may authorize one of two remedies. The corporation may either rescind the contract, return the property and receive back the stock or cash paid for the property, or it may sue the promoter for the secret profits or for any other damages. For example, a promoter cannot permit people with whom he deals to make unreasonable profits out of the corporation. If the promoter did permit such unreasonable profits to be made, the corporation would not be bound to recover those profits from the third person, but could sue the promoter for the damages, which would be measured by the unreasonable amount of profit paid to the third person.

Problems

1. Choose a business that you think might succeed in your local community and prepare a complete statement on the investigation, assembly, and financing of the promotion.
2. Mr. Brown, a professional promoter, was retained by the Mason Manufacturing Company to procure a suitable site in your locality and to erect a factory building. Mr. Brown found a suitable plot and purchased it for $10,000. He resold it to the company at the same price, but he also bought the adjoining piece for a similar amount. On the adjoining piece he erected a restaurant and parking lot which were successful solely as a result of the patronage of the Mason employees. Upon a sale of the improved plot, he realized a profit of $25,000. Is this a secret profit? Can the Mason Manufacturing Company recover any of this profit?

CHAPTER 11

Security Buyers and the Regulation of Issues of Securities

Approach to the subject. The securities of a going concern in need of additional capital, or of a newly organized company in need of initial capital, must eventually get into the hands of investors if the corporation is to raise the funds it needs. This chapter discusses the various classes of security buyers and explains why governments have taken measures to protect buyers of securities and what those measures are. Chapters 12 and 13 explain how the stocks and bonds get into the hands of these investors through investment banking houses and by private placement. Chapter 14 explains the operation and regulation of the securities markets through which outstanding stocks and bonds can be bought and sold.

Security Buyers

Classification of investors. The buyers of securities may be broadly classified as follows:

1. Investing institutions.
    - (a) Savings banks.
    - (b) Commercial banks.
    - (c) Trust companies.
    - (d) Investment trusts.
2. Institutional investors.
    - (a) Life insurance companies.
    - (b) Fire and casualty insurance companies.
    - (c) Eleemosynary institutions.
3. Pension and profit-sharing trusts.

4. Individuals.
   (a) Investors.
   (b) Speculators.
5. Business corporations.

Investing institutions. Investing institutions are those which invest other people's money—principally savings banks, commercial banks, trust companies, and investment trusts. Investment trusts will be treated separately in order to provide a fuller explanation of them.

Savings banks. The mutual savings banks are limited by state law in their purchase of investments. These laws, which vary from state to state, enumerate the kinds of securities that may be purchased. The securities that fit into the permissible categories form what is known as *legal investments* or the *legal list*. In New York, for example, the legal list consists of first mortgages on real estate, government obligations and state and municipal securities, railroad and public utility bond issues of companies that have been able to meet certain requirements as to earnings, stocks of trust companies that meet certain requirements, securities of business corporations, if the banking board determines that they are eligible under the statute, stocks of certain housing corporations, and a few other special kinds of securities. By and large, savings banks invest their funds in government and municipal securities and in real estate mortgages.

Commercial banks. The money that a commercial bank has for investment is made up of its demand and time deposits. The demand deposits include funds which depositors draw against by check. The time deposits include savings deposits just like those of a savings bank, and deposits of corporate and public funds. The place of the commercial banks in the investment market is complicated by the function of the commercial banking system in providing the nation with its money supply and its current cash.[1] In addition, the investment activities of the commercial banks are subject to banking laws and regulations. Generally, these statutes and regulations permit investment in United States Government bonds without restriction. They prohibit entirely investment in some types of securities; for example, stocks, with certain narrow exceptions. They limit the amount that can be invested in other securities; for example, a bank cannot invest more than 10 per cent of its capital and surplus in the securities of any one obligor. The securities they buy must be marketable bonds, notes, or debentures, commonly known as *investment securities*. They must not

[1] For an explanation of the place of the commercial banking system in the investment market, see *Fundamentals of Investment Banking*, sponsored by the Investment Bankers Association of America, Chapter 1, page 27 and Chapter 26 (Englewood Cliffs, N. J.: Prentice-Hall, Inc., 1949).

purchase securities in which the investment characteristics are distinctly, or predominantly, speculative. As a result of the function of commercial banks and the restrictions upon their investments, commercial banks invest principally in U. S. Government bonds. They buy some state and local government securities, and a small amount, comparatively, of long-term corporate bonds.

Trust companies. The investment of *trust funds* by trust companies is governed by state statutes, unless the creator of the trust has expressly made other provisions in the trust instrument.[2] The laws vary from state to state. Generally, they are of two types: (1) laws that enumerate the kinds of securities that may be bought (*legal-list* states), and (2) laws that give the trustee the right to buy anything which a prudent man would buy. In states where the *prudent-man rule* exists, the trustee is less restricted than in the legal-list states. The trustee, of course, always considers that it may become responsible for any loss if the courts decide that it did not act as a prudent man would in making the investment.

Investment trusts and investment companies. An investment trust, also called an investment company, is a corporation or business trust organized for the purpose of investing funds obtained through the sale of its own securities,[3] in stock, bonds, other obligations of various corporations, and in some cases in other types of property. The investment trusts are not regulated to the same extent as savings banks and trust companies from the viewpoint of the kinds of securities they may purchase. They are subject to the Investment Company Act of 1940, a Federal law administered by the Securities and Exchange Commission, which lays down broad rules governing the disclosure of the facts about the registered investment company and governs many phases of their operations.

The investment trust aims to afford investors greater safety of principal and a greater return on their investments than would be possible by individual investment. It accomplishes its purpose through diversification of risks and skilful management of securities. The investment trust does not seek to promote, finance, or control the corporations whose securities it purchases.

[2] Reference here is to funds held by trust companies as trustees under personal trusts. Investments for their own account, incident to the commercial banking business that the trustee may also be conducting, would be governed by the laws referred to above under commercial banks.

[3] The so-called "leverage" investment stocks are those whose capitalization includes preferred stock and bonds ahead of the common. Such shares, of course, are more volatile than those of single-class capitalization companies (non-leverage types of companies), since both asset coverage and income available fluctuate more widely. See *Fundamentals of Investment Banking,* sponsored by Investment Banking Association of America (Englewood Cliffs, N. J.: Prentice-Hall, Inc., 1949), page 727.

Investment trusts are a comparatively recent development in this country.[4] In 1920 only some forty such organizations were in existence. They increased rapidly in number during the following ten years, especially from 1923 to 1929. According to a report of the Securities and Exchange Commission,[5] 1,272 investment trusts and investment companies of all types existed between 1927 and 1936. As a result of numerous liquidations and reorganizations, only 559 investment trusts and companies were known to the Commission to be still active at the end of 1936. In June, 1957, there were 435 investment companies registered under the Investment Company Act of 1940. In the rapid development, the principles of investment that were the basis of the older investment trusts were more or less abandoned. In the older trusts, for example, diversification of investments was assured by limitations placed on the amount that could be invested in any one kind of security. Today, while many of the investment trusts follow the diversification principles, others limit their investments to securities of a specialized group, such as banks, public utilities, insurance companies, chain stores, and similar groups.

So far as the legal formation of investment trusts in this country today is concerned, only a few are created as Massachusetts trusts or common law trusts. Most of them are organized under the corporation laws of such states as Delaware, Massachusetts, Maryland, and other favorable states. In investment trusts of the corporate form, both the organization and the relationship of the owners to the corporation are the same as in business corporations.

Institutional investors. The institutional investors comprise principally life insurance companies, fire and casualty companies, and eleemosynary institutions.. Although these institutions are formed primarily for purposes other than investment, it will be clear from the following discussion why they constitute an important part of the market for investment securities.

Life insurance companies. The total of the reserves of all life insurance contracts issued by all life insurance companies constitutes a source of funds available to industry and to individuals to finance their homes and farms. The size of the funds constantly available for in-

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[4] Investment trusts originated in England and Scotland during the 1870's. Some writers point to the Massachusetts Hospital Life Insurance Company, incorporated in 1818 in Boston, as the earliest example of an investment trust. While incorporated as an insurance company, the principal business of this organization was the selling of expert investment service through the trust device.

[5] A study of investment trusts and investment companies was made by the Securities and Exchange Commission pursuant to Section 30 of the Public Utility Holding Company Act of 1935. The Commission's study dealt particularly with the years 1927–1936. It represents the most thorough treatment of the subject that has ever been made and should be referred to by anyone interested in investment trusts.

vestment makes the life insurance companies an important factor in the securities investment market.

The investments of life insurance companies are regulated by laws of the states in which they are organized, and to some extent by the laws of the states in which they operate. These laws, however, give a considerable degree of latitude to the investment officers of the companies, thus permitting exercise of investment judgment. Usually they can buy real estate mortgages if the mortgages are not more than a certain percentage of the value of the real estate. They can usually buy without limit the bonds of the United States Government and its political subdivisions. They can own, within limitations, Canadian Government and municipal or corporate securities. They can invest in securities of domestic corporations, including secured and unsecured railroad, public utility, and industrial bonds, and in preferred stocks, provided these domestic corporations meet certain tests. In some states, life insurance companies may even own a limited amount of common stock.

Several insurance companies have been licensed to sell *variable annuity contracts,* and there is considerable agitation in this direction by life insurance companies in several states. If these contracts become permissible under state laws generally, life insurance companies will become important buyers of common stock. Variable annuity contracts are designed to relieve annuitants from the hardship that inflation causes them. Payments are made in income units rather than in fixed dollar amounts, the value of the units varying from time to time. The variance is caused by investment of the annuitant's reserve in equity securities [6] rather than debt securities. This investment policy produces higher income for the annuitant during periods when equity earnings and prices are high, and lower income when adverse economic conditions prevail. Although stock market prices and living costs do not always fluctuate to the same degree, or even in the same direction, the risk of deviation is much less than the risk of being completely unprotected against dollar-value fluctuations.

It is the responsibility of the investment department of the life insurance company, subject to the finance committee's authority, to invest their funds in such a way that payment may be made to policy holders in accordance with their contracts. This problem is similar in many ways to the investment problems of other institutions or persons who depend on investment income, except with regard to the scale of operations.

Fire and casualty insurance companies. These companies sell insurance and therefore have no large investment element in their con-

[6] Because of the nature of the investment, variable annuities are also referred to as *equity annuities.*

tracts to accelerate the expansion of their assets. Nevertheless, their assets, which are substantial, are principally in the form of investments. Hence, they are an important type of investor.

Eleemosynary institutions. Another type of institutional investor that is a source of new capital includes churches, universities, hospitals, charitable foundations, philanthropic organizations, and other similar institutions that have large amounts of funds which they must keep invested for long periods of time, or indefinitely. Although such institutions may be restricted in their choice of investments by the donors of some of the funds, generally they have more freedom in acquiring securities than life insurance companies and institutions that invest and manage other people's money. They maintain investment management staffs or retain investment counsel to guide them in purchases of securities. In general, eleemosynary institutions are likely to invest in the same type of securities as persons dependent on investment income.

In recent years, the development of private deals has resulted in the direct negotiation between issuing corporations and institutional investors for the sale of entire issues of new securities. We shall see later in this chapter the part life insurance companies and eleemosynary institutions play in private placement; and in Chapter 21 we shall again find these institutions playing an important role in financing through the purchase-and-lease-back arrangement.

Pension and profit-sharing trusts. The phenomenal increase in pension plans and profit-sharing plans, especially the latter, has developed an almost exhaustless source of investment capital. The funds of the trust are invested by the trustees in accordance with the terms of the trust agreement. The agreement usually provides that the trustee shall not be bound by the laws applicable to trust companies, and gives him wide latitude in the selection of investments. Some agreements place a limit on the proportion of the fund that may be invested in the securities of any one issuer, or on the proportion that may be invested in a particular type of security. Others prohibit investment in the employer's securities, or limit the proportion of the trust fund that may be invested in employer securities. Some agreements give the trustee specific authority to invest in investment trusts. Present-day pension trusts, as well as profit-sharing trusts, require a dynamic investment program devoted primarily to common stocks.

Individual investors. Individual investors include buyers of securities who invest their own funds. They are not restricted in the purchase of securities by any rules except those of good sense. This group includes investors and speculators. In the former category are persons dependent on investment income and others who can assume some risk for the larger return involved; in the latter are professional traders

and speculators. Each of these types of individual investors buys the kinds of securities that especially appeal to his individual situation, as will be seen from the following discussion.

Persons dependent on investment income. People who control their own investments and who are dependent on the income from them, usually have three objectives in their investment program—first, conservation of capital; second, income; and third, appreciation. They purchase what might be called pure investment securities.

A pure investment provides the investor with a security possessing ready marketability, definite minimum rate of income, and great safety of principal. The investor assumes a minimum of risk and in return sacrifices control in the corporation, a high rate of income, or both. Among such securities are bonds protected by a mortgage on property whose earning power is several times the amount required for interest. To reduce the element of risk still further, the issuing corporation should be a going concern whose type of business and caliber of management personnel indicate promise of stable earnings. Preferred stocks of well established corporations with excellent dividend records (especially when such stocks are cumulative and have preference as to assets) are given a high investment rating.[7] Common stocks generally fall short of a high investment rating, since their value moves too freely with the fluctuating earnings of the corporation. However, the standard of investment security is approached by the stocks of corporations that supply an article or service for which there is a constant demand, engage in an industry with thoroughly understood and standardized processes, offer a low financial risk, hold an established record of dividend payments, present an excellent financial history, and are undisturbed by poor management or manipulation by controlling interests.

Other investors. These investors may take a greater risk than people whose sole income is likely to be derived from their investments. Although such investors are willing to take some risk, in choosing their investments they demand a fairly high rate of income. The company whose securities they select need not have an established record, nor need it be more than a going concern of recent organization whose

[7] Several publishers of investment services undertake to compile all information pertinent to securities of corporations and to publish ratings of securities for which statistical material is available. The best-known agencies are Moody's Investors Service, Standard and Poor's Corporation, and Fitch Publishing Co., Inc. The ratings take the form of symbols, which are explained in the particular publication. It behooves the company management, where such rating is given, to maintain for its securities as high a position as possible. Indeed, every corporate official ought to look ahead to the day when the securities of his company will be rated. In the meantime, if proper attention is given to the factors that make for good rating, securities will be more salable than they would be if the investor's viewpoint were entirely neglected until the very moment when a new issue is about to be launched.

managers, they feel, can take advantage of a growing market for the company's product. In any event, the corporation must be substantial and the outlook must promise stability. The investments of these security buyers embrace most preferred and many common stocks of strong industrial companies.

Speculators. Individuals who can afford to accept temporary losses, or total losses in case their judgment was wrong, usually look for securities that hold promise of an increase in value. They are not attracted by high-grade bonds, which offer little opportunity for large investment profit. Of greater appeal are the common and preferred stocks and bonds of companies whose present positions offer opportunity for substantial improvement. They are also interested in securities of newly organized companies, with good prospects, and in stocks of such speculative ventures as promising oil and mining projects. Such investors are rewarded in proportion to their skill in analyzing correctly the profit possibilities of the venture, and are penalized for their errors in judgment. The owners of venture capital organizations referred to at page 190 are speculative investors.

Business corporations as investors. Companies whose activities fluctuate because of seasonal need may have large sums of cash idle for two to six months. Since the time when the funds will be needed can be predicted with considerable accuracy, it is usual to invest such funds in short-term United States Government securities or bank certificates of deposit. The rate of return will vary in direct relation to variations in the money market and the rediscount policies of the Federal Reserve Board.

When funds that have been scheduled for investment in plants and equipment and for other capital expenditures are to be held for a long period, they may be invested in United States Government bonds maturing at about the date the funds are expected to be required. If the date is uncertain, short-term issues would be purchased. Government securities have the advantages of liquidity, safety of principal, and acceptability as collateral for low-rate bank loans up to 100 per cent of the face value of the collateral. Bankability is often important where temporary increases in working capital are required for emergencies.

Some corporations have investments in securities of subsidiary or affiliated companies. These are generally regarded as fixed investments since they are usually held for purposes of control. Sometimes a business corporation will invest in the securities of a supplier or other creditor. In some instances, investments are made in marketable securities of unrelated companies. However, since corporations are compelled by the penalty surtax provisions involved under Section 531 of the Internal Revenue Code (see page 411) to distribute to stockholders any surplus cash not needed for future business purposes,

there is always a limitation on the accumulation of funds available for investment in securities of other corporations.

Development of public interest in investments. From the above description of the groups of investors in corporate securities it is clear that among them are informed investors and inexpert investors. The former know how to use sources of information that analyze a security offering, and can measure the risks they run in buying a particular stock or bond. The latter know little or nothing about determining the merits of an issue. Unless properly advised, they are easy victims of the unscrupulous promoter, security salesman, or dealer who offers a promise of quick and large profits on a small initial investment. The interest of the uninformed investor in buying securities has developed steadily with the tremendous growth of the American corporation.

In the earliest days of security selling, the group of public investors was not very large. They were offered principally the stocks and bonds of companies organized to build canals and highways. Interest in buying securities grew considerably immediately following the Civil War because of the widespread efforts that had been made to sell United States Government bonds to individuals and institutions. When the railroads began to develop after the Civil War there was thus a larger group of people ready to put their savings into the stocks and bonds of promising new enterprises. A little later, when the industrial combinations were being formed and the public utilities began to be organized, the investment market broadened further. Finally, with the education of the public in the investment of securities through the widespread sale of Liberty Bonds during World War I, millions of Americans became security buyers.

Throughout this development the public proved gullible to the promises and tricks of shrewd stock salesmen who peddled spurious stocks. Security frauds mulcted the public of more than a billion dollars annually. The tales of lost savings and inheritances were pitiful, but there were always more names for the "sucker lists" and more dupes to respond to the "hurry-hurry" call not to miss "the opportunity of a lifetime." Naturally skeptical people bought their securities from conservative investment bankers and dealers who had become the intermediary between the issuer of securities and the investing public.[8]

The 1920's witnessed the most phenomenal growth in public interest in security issues. Spurred on by general prosperity, the public's appetite for speculative securities seemed insatiable. Even investment bankers, who had previously exercised cautious judgment in the types of securities they originated, lowered their standards and offered in-

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[8] See page 228.

vestors unsound and unseasoned securities of domestic and foreign corporations and of foreign governments. Corporations took advantage of the ease with which common stocks could be sold to refinance their existing indebtedness through offerings of common stock rather than bonds. High-pressure security selling methods accelerated the pace of the sales. Security issues were offered even by reputable investment houses without adequate investigation. The momentum of security selling had become so swift that there was no time for investment houses and dealers to think about proper standards of investment appraisal or to provide even the most fundamental safeguards to investors. The boom culminated in the terrific collapse of the stock market in 1929, leaving a sad but perhaps wiser investing public. The experience brought on a consciousness that the corporation had become a major social institution and that the offering of securities to the public had become allied with a national public interest. It led to important measures to safeguard investors against a repetition of the experience. These measures will be considered presently.

Education to induce the "little man" to invest started anew with the sale of government bonds during World War II. In the post-war period, special efforts were made by security dealers, through lectures and exhibitions at public meetings, to acquaint new potential investors with the fundamentals of investments. The result of the continuous growth of public interest in buying securities is visible in the steadily increasing number of shareholders in American corporations.[9] A recent development that will increase the number even more is the *monthly investment plan,* devised by the New York Stock Exchange. Through most securities brokers, investors may buy one or more designated securities by making monthly payments. The monthly payment need not be the price of an exact number of shares of stock. The fractional amounts are credited to the account of the investor. The amount of the monthly investment remains the same, even though stock prices fluctuate.

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[9] From the period 1916 to 1921, a great diffusion of ownership occurred, with wealthy people representing a much smaller proportion of all corporate stockholders in 1921 than had been the case prior to 1916. From 1921 to 1927, the proportion represented by large stockholders remained fairly constant, in spite of the increase in the number of stockholders of record. See "Diffusion of Stock Ownership in the United States," Gardiner C. Means, *Quarterly Journal of Economics* (August, 1930). This study shows that the total number of stockholders in 31 large corporations for which information was available from 1900 to 1928, increased steadily from 226,543 in 1900 to 1,419,126 in 1928. A later study shows that from 1929 to 1933, common stockholders in 50 leading corporations increased from 1,626,000 to $3,500,000. See H. J. Loman, "Changes in Secondary Distribution of Equity Securities," 33 *Journal of American Statistical Assn.* 21 (1938). In a booklet put out by the New York Stock Exchange, *Who Owns American Business?* (1956), it is reported that at the end of 1952 there were 6,490,000 people owning stock in publicly held corporations. By the end of 1955, the number had increased to 8,630,000.

Regulation of the Issuance and Sale of Securities

Need for protective measures. With the development of public interest in investments, the need to protect the uninformed and gullible investor from fraud and over-sanguine estimates of future profits became urgent. Both Federal and state laws, with the basic purpose of protecting the public from fraud, have been passed to regulate the issuance and sale of securities. Thus the Federal law, the Securities Act of 1933, is sometimes called the "Truth-In-Securities Law." The state laws are termed blue-sky laws because of their purpose of preventing "speculative schemes which have no more basis than so many feet of blue sky."

Federal regulation of security issues. Following the 1929 stock market crash and the ensuing depression, Congress enacted the Securities Act of 1933, to regulate the issue of new securities, and the Securities Exchange Act of 1934, to safeguard the public in security transactions through stock exchanges and other securities markets. Here we are concerned only with the Securities Act of 1933. The Securities Exchange Act of 1934 and other regulatory acts will be discussed in Chapter 14.

We have referred to the Securities Act of 1933 throughout this text wherever it has had relation to the subject under discussion. It requires that before new offerings of securities are made to the public by the use of the mails or the channels of interstate commerce, specific detailed information concerning the new offerings must be disclosed in a registration statement (see page 224) that must be filed with the Securities and Exchange Commission. Similar information must be disclosed in a prospectus (see page 225) that must be delivered to each buyer of the registered security before or at the time of the completion of the transaction.

Exempt securities and transactions. Registration, the act of filing a registration statement, is required for all classes of securities—that is, stocks, bonds, debentures, notes, voting trust certificates, and the like—except those specifically exempt from the Act. The exempt securities include: (1) United States Government obligations; (2) territorial bonds; (3) obligations of Federal instrumentalities, such as Federal land bank bonds; (4) state and municipal obligations; (5) railroad securities; (6) short-term paper; (7) securities of building and loan associations; (8) receivers' certificates; (9) securities of nonprofit organizations; (10) insurance policies and annuity contracts; (11) securities issued in reorganizations approved by a court or governmental authority; (12) securities exchanged by the issuer with its existing security holders exclusively where no commission or other remuneration is paid or given directly or indirectly for solicit-

ing the exchange; and (13) securities that are part of an issue sold only to residents of the state in which the issuer is incorporated and is doing business.

In addition, small issues aggregating less than $300,000 are exempt from registration. However, the issuer must file a brief notice with the Securities and Exchange Commission.

The classes of transactions that are exempt from the Act include: (1) transactions by persons other than the issuer, underwriter, or dealer; (2) transactions in new issues, not through an underwriter, and not involving a public offering; and (3) brokers' transactions executed upon unsolicited customers' orders.

The registration statement. The registration statement is filed in triplicate with the Securities and Exchange Commission and a filing fee is paid.[10] It is a voluminous document, usually prepared by the lawyers, accountants, bankers, and experts in conjunction with the issuing company's staff. In order to comply with the basic purpose of the Act "to provide full and fair disclosure" concerning the securities to be issued, the registration statement includes all pertinent facts about the history, business, and properties of the company, together with audited financial statements and schedules. It also includes a statement of the uses to which the proceeds from the sale of securities are to be applied, a full description of the proposed securities, and the arrangements for selling the issue, such as the commission to be paid to bankers. The registration statement also contains the names and addresses of directors and officers, experts who contributed to the preparation of the statement, and numerous exhibits such as copies of resolutions, by-laws, charters, and various agreements as well as a sample of the certificate for the security to be offered. The voluminous nature of the registration statement arises from the desire of the issuer and the underwriters to escape any civil liability that might be imposed for failure to make a full disclosure of all material facts.

No offering of the proposed securities may be made until the registration statement is declared to be effective. Usually this does not take place until at least 20 days after the filing. The 20 days "cooling-off period" is used by the SEC's staff to examine the registration statement thoroughly to make certain that it complies with all provisions of the Act.

The Securities Act gives the SEC the right to compel correction of the registration statement both before and after the effective date. This right the Commission exercises through a device known as a "letter of deficiency." If the corrections requested in the letter of deficiency are not made, the SEC may bring stop order proceedings, sus-

[10] The Commission immediately makes public that a registration statement has been filed. This gives rise to widespread publicity released by financial news services, financial writers, and newspapers generally.

pending the right to sell the issue, preventing the use of mails and facilities of interstate commerce to sell the securities, and serving as a warning to the investing public that the Commission has found the statement is untrue and misleading.

Prospectus. Relatively few people inspect the registration statement. After the effective date, the sale of a registered security must be accompanied or preceded by the delivery of a prospectus to the purchaser. The purpose of requiring a prospectus is to secure for potential buyers the means of understanding the nature of the securities that they are invited to buy. The information required to be shown in the prospectus is practically the same as that included in the registration statement, except that under rules issued by the Commission certain information contained in the registration statement may be omitted from the prospectus.

Every prospectus is required to set forth the following legend in boldface on the front page:

> These securities have not been approved or disapproved by the Securities and Exchange Commission nor has the Commission passed upon the accuracy or adequacy of this prospectus. Any representation to the contrary is a criminal offense.

Certain requirements are set up by the Act for keeping the information in the prospectus up to date in cases where it is used more than nine months after the effective date of the registration.

The prospectus is actually an integral part of the registration statement. It is so formidable a document that, in the opinion of some people, the investor gets less understandable information than formerly. One of the reasons why the prospectus is so formidable is the attempt by the issuer and the underwriters to escape any possible civil liability that might be imposed for failure to make a full disclosure of material facts. An investor may get a better understanding of the offering from the "newspaper prospectus." [11] This is a one-page summary of the issue, the issuer, and the underwriters' commissions. This type of prospectus usually appears as an advertisement in newspapers and magazines and as the first page of the required prospectus.

At the head of every newspaper prospectus, the following statement appears in conspicuous print:

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[11] The newspaper prospectus should not be confused with the "tombstone prospectus," which is another form of announcement of a security offering. The latter merely gives the name of the issue, the price, and the names of the investment bankers distributing the issue. It includes two statements to take into account the requirements of the Securities Act. One shows that the advertisement is neither an offer to sell, nor a solicitation of an offer to buy any of the securities, and that the offering is made only by the prospectus. The other indicates that copies of the prospectus may be obtained only from such of the investment bankers named in the advertisement as may legally offer the securities in the state.

These securities, though registered, have not been approved or disapproved by the Securities and Exchange Commission, which does not pass on the merits of any registered securities.

At the foot, in conspicuous print, is the following:

Further information, particularly financial information, is contained in the registration statement filed with the Commission and in a more complete prospectus which must be furnished to each purchaser and is obtainable from the following persons. (Here the names are inserted.)

Effect of Securities Act of 1933 on security frauds. The Securities Act of 1933 has undoubtedly prevented the distribution of millions of dollars of worthless securities. In 1935 the Securities and Exchange Commission established its securities-violations files, for which it has steadily assembled information relating to security frauds. The Commission co-operates with the Post Office Department, the Federal Bureau of Investigation, the state securities commissions, Better Business Bureaus, and other agencies in gathering and disseminating information. The Commission thus serves as a clearing house for information on security frauds.

That the Act and the efforts of the Commission have not wiped out fraudulent promotions is clear from the fact that the Commission has litigated numerous cases involving the use of fraudulent devices. Prosecution by the Department of Justice has resulted in the imposition of fines and prison terms. No matter how much progress is made toward controlling the distribution of fraudulent securities by refusal to permit unsatisfactory registration statements to become effective, by the issuance of stop orders, by the prosecution of individuals under the Act, and by vigorous campaigns against persons defrauding the public, there will always be need for the individual investor to look for the earmarks of fraud in security issues.

Supervision under the Public Utility Holding Company Act of 1935. The Public Utility Holding Company Act, which is administered by the Securities and Exchange Commission, requires registration by companies which own or control 10 per cent of the voting power of retail electric and gas companies, or which otherwise exercise a controlling influence. The Commission exercises jurisdiction over such registered holding companies and their subsidiaries with respect to the issuance of securities, security transactions, intercompany loans, and other financial and administrative matters.[12] A declaration must be filed with the Commission with respect to any proposed issue of securities. The declaration becomes effective unless the Commission finds that the security issue fails to meet the standards set forth by the Act for determining the financial structure of a company and the

[12] See page 498 for further discussion of other methods of controlling holding companies under the Public Utility Holding Company Act of 1935.

nature of the securities which may make up that structure. Sales cannot be undertaken until a registration statement under the Securities Act of 1933 has become effective.

State regulation of security issues. The Federal Securities Act of 1933 is not designed to interfere with the operations of state securities laws. Although state securities laws or blue-sky laws are not as demanding as Federal legislation for securities listed on a national exchange or for securities of admitted strength, such as public utility securities, they are so numerous and varied that they provide another type of problem and expense for the issuing company.

State securities laws are generally divisible into three main categories: (1) the "fraud-type" law, (2) regulation by controlling the distributor or seller, and (3) regulation by controlling the issuer. Most of the states have enacted legislation providing for both the licensing of dealers and salesmen and the registration of securities. With respect to the registration of securities, some states provide for registration by notification (generally limited to admittedly strong securities of companies that have had good earnings records over a long period of time) and registration by qualification. Qualification is required of all securities not exempt from the law or entitled to registration by notification. It requires the filing of a prescribed form providing for statements, exhibits and documents concerning the issuer's business in considerable detail. Both types of registrations usually require that a filing fee must accompany the application. In regard to supervision, most state securities departments have broad investigatory powers and may subpoena the attendance and testimony of witnesses and the production of books and papers relating to any matter over which it has jurisdiction.

Problems

1. Mr. Edwards has asserted in a speech that corporations are owned by the rich few in America. In refutation of this statement, choose three corporations and determine, as far as possible:
   (a) How many stockholders each company has
   (b) What groups hold the stock (men, women, institutions, etc.).
   (c) Where the stockholders are located geographically.
   (d) The number of shares owned on the average.
   (e) How much stock is owned by the largest stockholder.

2. Secure a copy of any prospectus and determine:
   (a) The contents in general.
   (b) The entire cost to the company of issuing the security other than commissions (attorney's fees, etc.).
   (c) What use the corporation will make of the proceeds.
   (d) Whether or not there is to be market stabilization and, if so, for how long a period.
   (e) What commissions will be paid by the corporation. What percentage of the selling price is this?

CHAPTER 12

Distribution of New Securities

Introduction. In this chapter and the next we are concerned with the processes by which a corporation's new issues of stocks and bonds get into the hands of the classes of investors described in the preceding chapter. In this chapter we shall discuss the distribution of new securities through investment bankers and, also, the functions of investment bankers relating to outstanding securities. In the following chapter we shall treat the distribution of new securities where the offering is made directly to investors by the corporation.

Distribution Through Investment Bankers

Economic role of investment banking. Although in some instances the issuer sells its securities directly to the investor (as in the case of so-called private placement with institutional investors),[1] generally the primary distribution of securities is performed by the investment banking industry.

The economic role of investment banking has been summarized as "that of gathering surplus funds from many millions of persons directly and through financial institutions, and making these funds available to business enterprises and to public bodies that require these savings in large amounts in order to expand the output of goods and services, to raise living standards, and in the process of doing this to furnish employment. The investment banking mechanism may be likened to a middleman, standing between those who accumulate savings and those who require savings for new investment." [2]

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[1] See page 244.

[2] Jules I. Bogen, "Economics of Investment Banking," *Fundamentals of Investment Banking,* sponsored by Investment Bankers Association of America (Englewood Cliffs, N. J.: Prentice-Hall, Inc., 1949), p. 4.

Primary function of investment banking. The primary function of investment banking, as indicated in its economic role, is participation in the formation of new capital for new and established businesses and for state and local government bodies.

This statement does not mean that financing without investment bankers is at all times impossible. However, the services of the investment banker are generally useful and helpful to the corporation seeking new capital. In brief, his services may be summarized as follows:

1. He provides advice with respect to what is needed to market successfully new securities. This advice is based upon a background of experience and contact with securities markets and with other similar companies floating new securities.
2. He works out the details of the financing, including the preparation of the SEC registration statement and prospectus, if they are needed;[3] arrangements with lawyers, accountants and engineering firms; and compliance with legal requirements. He also provides for needed adjustments in the provisions of the securities to create a maximum attractiveness for investors.
3. He insures the raising of the capital by forming a banking group, known as a *syndicate*, to purchase the securities and assume the risks of selling them to ultimate investors.
4. He follows up the financing with a continuing interest in the corporation's securities by making markets in them after the deal is completed. This is sometimes termed "sponsorship" of the securities.

The modern investment banker performs a number of other functions that are subordinate to capital formation and that are associated with outstanding securities and securities markets. These functions, although not connected with new issues, are treated at the end of this chapter.[4]

Methods of financing by investment bankers. The primary function of investment bankers—raising new capital—may be carried out through (1) outright purchase and sale of securities offered by the issuers, (2) "standby" underwriting, or (3) "best efforts" selling.

Purchase and sale of securities offered by an issuer. The principal method by which investment bankers participate in the formation of capital is through the purchase outright, alone or with other investment bankers (the purchase or underwriting group or syndicate), of the securities offered by the issuer and the sale of the securities to investors of the types already described. This outright purchase is known as *underwriting*. The investment banker's profit is the difference between the price he pays for the security and the price for which he sells it (the "spread"), less selling commissions and other expenses.

[3] See page 223.

[4] See pages 258 et seq.

"Standby" underwriting. Under "standby" underwriting, the investment banker, or a group of bankers, enters into an agreement with an issuer to "take up" and sell securities previously offered by the issuer to other prospective buyers, but not sold. The most common situation in which a standby agreement is used occurs when the corporation issues to present common stockholders "rights" to subscribe to an additional issue of common stock at a certain price within a limited period of time. Under the standby agreement the bankers purchase and distribute any of the shares not subscribed for by the holders of rights.

Standby underwriting has become more popular and less expensive in recent years as a result of changes in the underwriting agreement that have granted greater latitude to the underwriters in hedging their risk by being permitted to buy in rights and "lay-off" stock during the subscription period. By "lay-off" is meant the sale of stock against the purchase of rights. For example, if it is known that certain large stockholders will be unable or unwilling to subscribe for the new stock, the underwriters may be permitted to purchase their rights, subscribe for the stock and sell it during the subscription period.

"Best efforts" selling. In "best efforts" selling, the investment banker acts simply as agent for the issuing corporation, utilizing the best efforts of its organization, and other organizations with which it may associate itself, to distribute as much of the offering as it can. The investment banker does not purchase the issue and makes no commitment. The issuer thus obtains no assurance that the entire issue will be sold and the desired capital obtained. For this reason best efforts selling is used in the case of highly speculative issues that no banker will actually underwrite. Such issues are usually common stocks the saleability of which, either because of the size of the issue or its quality, is in conisderable doubt. Because of this doubt, it becomes cheaper for the issuer, if circumstances permit acceptance of the possibility of selling less than the whole issue, to sell as much as possible at a cost for *selling* only, than to pay a larger than usual amount to the investment banker for the extra risk that would be involved in outright purchase. The best efforts method is also used in the case of a seasoned and well established security which, it is known, will sell fairly well and which is not required by the issuer to be sold in entirety anyway. The investment banker's profit in this type of transaction is a predetermined commission on each unit distributed.

Institutional organization of investment banking. Although we shall deal principally in this chapter with the *merchandisers* of securities, the student should keep in mind that institutions which comprise the investment banking system, in the broadest sense, include firms that perform the primary function of investment banking just described or

functions that are associated with outstanding securities and security markets.

There are many types of underwriting or investment banking houses. A small company may use a local securities dealer as its investment banker. This securities dealer may sell the securities of the company to a number of local investors, creating an over-the-counter market in the company's stock. If the company grows to a size where nation-wide distribution of its securities is feasible, the local securities dealer may take the business to one of the large national investment banking firms that have more capital and are able to arrange underwriting groups or syndicates.

Investment banking firms include (1) firms engaged primarily in the initial distribution of securities, (2) member firms of national security exchanges that are primarily stock brokerage or wire houses, (3) over-the-counter dealers who are not members of an exchange, and (4) various types of security-buying institutions. The term "investment banking" is usually applied to all of the functions performed by investment bankers, to the institutions that perform the functions, and to the procedures by which they are carried out.

Certain of the larger firms specialize in managing nation-wide groups of other investment bankers in underwriting and selling issues of nationally known companies, requiring nation-wide distribution of their securities. These are commonly called national underwriters and have their principal offices in New York or Chicago. They are usually equipped to handle all of the various functions of the investment banking business, although they may have particular specialties on which they concentrate their attention. Most of these firms are retailers as well as wholesalers of securities; that is, they sell to individuals as well as to dealers in the selling group. They may sell, also, to institutional investors or to investing institutions. This procedure is known as *institutional selling,* as contrasted to retail selling to the individual investor.

In between the large national investment banking houses and the small local securities dealers are many intermediate-sized local underwriters who do not ordinarily manage alone large issues of nationally known companies but who do manage underwritings of issues of local companies and participate in national underwriting and selling groups.

Departments of investment banking firm concerned with primary distribution. The typical sizable investment banking firm has a number of functional divisions or departments. From the standpoint of types of securities, there may be a corporate department, a government bond department, and a municipal department. A more significant division along functional lines is the buying department, sales depart-

ment, syndicate department, trading department, research department, and accounting and treasury department. These names are fairly descriptive of the functions performed. For example, the buying department establishes the first contact with the issuer of securities and works out the terms. The sales department maintains contacts with various types of potential purchasers of securities. The syndicate section works on the formation of groups of underwriters and dealers and on the allocations of securities among the various members of the syndicate. The trading department's main function is to maintain continuing markets in outstanding issues. The research department maintains files of information and analyzes the securities being underwritten or traded in. In effect, this department services all the other departments. The accounting and treasury department keeps records of the sales and purchases and cash settlements due. In a successful investment banking firm all these departments are closely integrated and work together harmoniously in day-to-day operations and in the consummation of special deals.

Underwriting procedure in negotiated financing. Financing with underwriters may be accomplished either by negotiated underwriting or through competitive bidding. The latter is sometimes referred to as the "sealed bid" method of financing and will be explained later.[5] Negotiated underwriting means that the terms and details of the financing operation are worked out or negotiated between the issuer and the investment banker on much the same basis as a contract is drawn up between the company and its lawyers or accountants for legal or accounting services. Once a contact has been arranged between a company that wishes to raise new capital through the issuance of securities and an investment banking house (known as the originating banker), the steps involved in consummating the deal are as follows:

1. The buying department of the originating investment banking house makes a preliminary investigation of the issuing company. This investigation may include an analysis of the company's business, its financial statements, physical properties, management, and other conditions. If the problem is complex, outside engineering firms or lawyers may be called in to provide reports on certain phases of the business. On the basis of this study, the investment banker will be able to decide whether financing can be done and to advise the company as to the most suitable type and amount of new securities that should be sold. The investment banking firm may then negotiate with the issuing firm an informal agreement, which covers the proposed amount and type of securities to be offered and a tentative time schedule for the offering.

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[5] See page 237.

2. The originating investment banker may invite other banking firms to join with it as underwriters in buying the securities. It forms the underwriting account with those who agree to join. The size of the group will depend on the size and nature of the proposed issue. Usually the originating investment banking firm will become the manager of the underwriting account, alone or jointly with co-managers, and will act as representative for the group.

3. If the deal requires registration with the Securities and Exchange Commission (SEC), the registration statement will have been prepared and filed and preliminary prospectuses [6] will have been sent to members of the underwriting group.

4. An agreement is drawn up between the participating members in the underwriting group and the manager. It is sometimes called the *agreement among underwriters*. In addition, the agreement between the issuing corporation and the underwriters is prepared. This agreement is called the *underwriting agreement* or *purchase contract*. After the price and spread [7] have been negotiated, the terms will be inserted in these contracts prior to signing.

5. If one is needed, a selling group will be made up by the originating underwriter acting as manager, from among selected dealers who will participate in selling the securities to the public.

6. The manager and the issuer negotiate the price and spread. The agreement among underwriters and the purchase contract with the issuer are then signed, subject to clearance by the SEC.

7. At this point the securities are sold to the public, subject to delivery after the closing.

8. All that then remains is the closing, and the termination of the agreement among underwriters and of the selling agreement. At the closing date, the issuing corporation makes delivery of the securities to the manager as representative of all the underwriters and receives payment therefor in accordance with the provisions of the underwriting agreement.

9. At the termination of the selling group, but not before the closing date, the originating investment banker makes settlement with the dealers in the selling group. At the termination of the agreement among the underwriters, the originating banker makes settlement with the

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[6] The preliminary prospectus is printed in a large quantity after amendments of the registration statement required because of deficiencies cited by the Commission have been filed. This prospectus has a legend in red ink at the side of each page stating in language prescribed by the Commission that the prospectus is not final and has not yet been declared effective. This practice has given rise to use of the term "red herring prospectus" in referring to the preliminary prospectus. The red herring may be shown to the public for information purposes, but not as an offer for sale. Thus no price appears on it.

[7] See page 236.

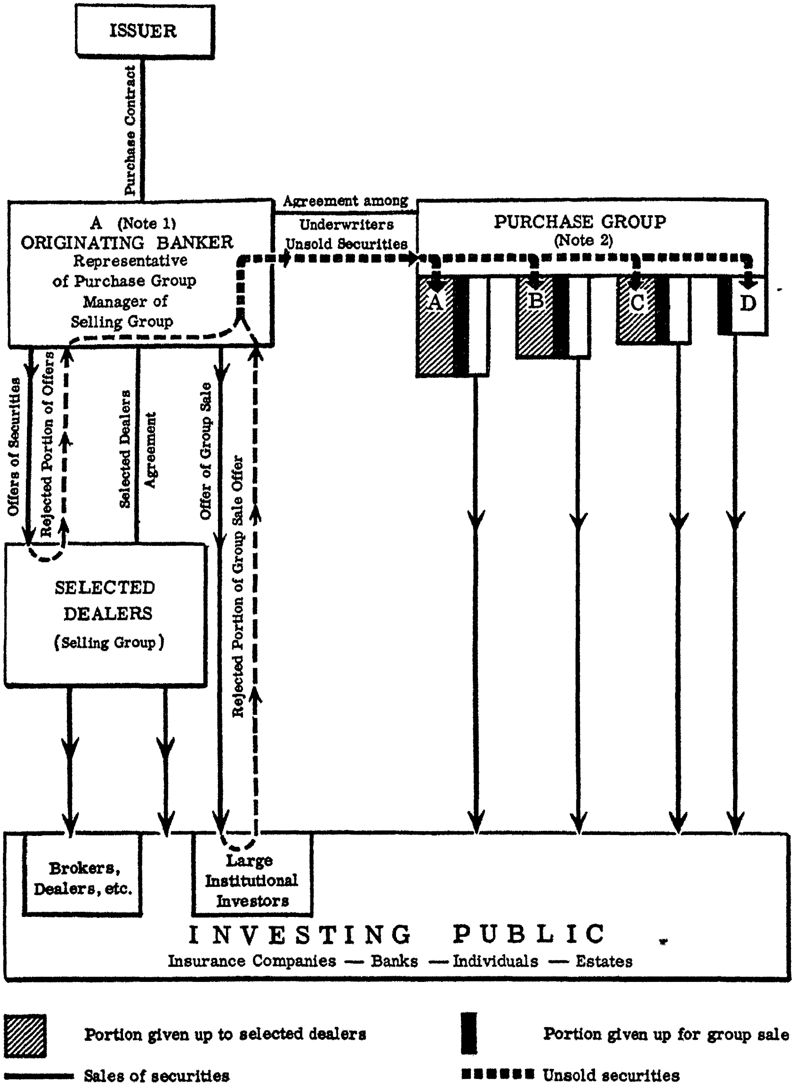

Chart Illustrating Syndication of an Issue of Securities Purchased by Investment Bankers.

NOTES: (1) "A," originating banker, and "A" in the Purchase Group are the same.
(2) The number of underwriters may be large; only four are shown in the diagram. The portion given up for sale by selected dealers may be smaller than is indicated in the chart, may be less for some underwriters than for others, and may be none at all, as shown for "D."

members of the underwriting or purchase group. The underwriters take up any securities reserved for the selling group that are not sold when the underwriting group terminates.

The diagram on page 234 illustrates the distribution of an issue of securities purchased by investment bankers.

Contents of the underwriting agreement. The issuer of new securities is particularly interested in the underwriting agreement or purchase agreement since this is the document that spells out the terms of the deal between issuer and underwriters. Under this agreement, the members of the underwriting group agree to buy the issue subject to the registration statement becoming effective. Among the provisions of the agreement are:

1. Complete designation and amount of issue.
2. A statement by the issuer that a registration statement and prospectus have been filed with the SEC and that these documents are in compliance with the law.
3. An agreement of the issuer to sell and the underwriters to purchase such amounts of the issue as have been determined for each purchaser.
4. A statement of the price the issuer will pay and the public offering price for the securities. This section may also contain a statement of the selling concessions to be granted to dealers.
5. A statement as to the date and place of closing.
6. Provisions that the company will pay all expenses incurred in preparation of the registration statement and prospectus, the qualification of the issue under the blue-sky laws of various states, and the issuance and delivery of the securities; and that the company will furnish copies of the prospectus in such quantities as the underwriters may reasonably require.
7. Indemnity agreements by the company, and also by the underwriters, that each will indemnify the other for claims arising out of alleged untrue statements of a material fact included in the registration statement and prospectus on the authority of each.
8. Conditions that affect the obligation of the underwriters to buy the securities. These include the conditions that the registration statement becomes effective, that legal opinions as to the legality of the issue have been received and that an affirmation has been made that the representations of the issuer are true and correct, and certain other conditions.
9. Various other provisions providing for changes in market conditions through wars, catastrophies, or unforeseen happenings. The "market out" clause usually states that if prior to the public offering but not later than 24 hours after the registration statement has become effective, political, financial, or economic conditions in general are

such as to make an offering impractical in the opinion of underwriters, they may be relieved of their obligation. This provision is very rarely invoked and is interpreted as applying only to most unusual conditions.

Spreads on negotiated deals. The underwriters fix the price at which the securities are offered to the public. The offering price less the price paid to the issuing company is the "spread" or compensation for the underwriters.

In a negotiated deal, the gross spread that each underwriter receives is normally divided approximately as follows: 10 per cent to the managers, 30 per cent for the underwriter himself, and 60 per cent to members of the selling group as the "selling concession" on securities purchased by the underwriter but "given up" to the selling group for retail sale. Actually, the practice varies and in many cases the underwriting spread is larger than the selling commission. Spreads, of course, will vary widely, depending upon the type, size, and quality of the securities, as well as the market conditions at the time of the sale. On the securities the underwriter retails himself, he, of course, keeps the selling commission.

Unsuccessful offerings. If the underwriters are unable to sell the issue during the period of the agreement among underwriters, there are two possible courses of action. (1) Any securities that were supposed to be sold to the selling group or to institutions and that remain unsold may be distributed to the underwriters. The distribution is proportionate to the original "give-up" by the purchase group members to the syndicate manager. (2) The agreement among underwriters may be extended in the hope that the securities can be sold during the extended period.

Competitive bidding for security issues. Having explained the procedure by which a negotiated offering of securities is purchased and distributed by investment bankers, we are now ready to see how public sealed bidding operates.

For many years almost all of the states have required public sealed bidding for municipal issues. Since 1941, the Securities and Exchange Commission has required this form of bidding, with certain exceptions, for all issues of registered public utility holding company securities and their subsidiaries.[8] In May, 1950, the Federal Power Commission promulgated an order requiring public sealed bidding for new issues, with certain exceptions.[9] Also, many state Public Service Commissions require public sealed bidding on public utility issues. In 1944, the Interstate Commerce Commission adopted the principle

[8] S.E.C. Holding Company Act Release No. 2676, April 7, 1941, ordering adoption of Rule U-50, summarizes the Commission's arguments.

[9] Federal Power Commission Order No. 152, Docket No. R-114.

of public sealed bidding for all public sales of railroad securities over $1,000,000, with certain exceptions. Public utility financing has constituted the bulk of money financing in recent years. For that reason, public sealed bidding has accounted for a large proportion of total underwriting.[10] However, only a few of the industrial companies doing new financing have adopted competitive bidding.

The desirability of public sealed bidding for securities has been a very controversial subject. Alleged advantages include: (1) the obtaining of a higher price and a smaller spread for high grade standardized issues; (2) the automatic determination of fairness of price and spread for regulatory bodies; (3) the minimizing of underwriting concentration among a relatively few large firms. Disadvantages cited include: (1) inflexibility of the procedure under unsettled market conditions due to a rigid time table; (2) difficulty of operation when the issue is small in size, not well known, or affected by an unfavorable earnings record or other factors requiring "selling"; (3) unwarrantedly high prices for issues in rising markets when competition is keen and unwarrantedly low prices in declining markets when competition is less keen; and (4) reduction in gross spreads and hence inadequate incentive to take underwriting risks or risks as selling group members.

No attempt will be made to go further into the pros and cons of competitive bidding here; the interested reader is referred to the various studies available on the subject.

Underwriting procedure in competitive bidding. The underwriting procedure under competitive bidding is quite different from negotiated underwriting in the steps up to the award of the issue to the highest bidder; thereafter, the procedure is much the same. When the news comes out that a certain company is planning to file a registration statement covering a new issue, various underwriters seek to form groups to bid for the securities, even though the exact amount and time of offering are not yet known. The manager will attempt to form as strong an account as possible. This must be done quickly, since there is keen rivalry in account formation. After the account is set up, usually by telephone, a letter confirming membership is sent out to each participant. The letter usually fixes tentatively the amount of each underwriter's participation.

When the issue is put into registration by the prospective issuer, copies of the registration statement and proofs of the bidding documents (invitation for bids, terms of offering, purchase contract and

[10] Of total public utility bonds offered publicly in 1955, approximately 70 per cent were offered competitively and about 30 per cent were negotiated. Electric and telephone and telegraph companies, for the most part, offered their bonds competitively, while the gas companies favored negotiated sales.

form of bid) are sent to those firms that head the bidding groups. The manager of each group talks to dealers and institutional investors and then has a preliminary price meeting with members of the group at which price views are exchanged. These views are refined later at a final price meeting just prior to submitting the bids. Since the manager has done substantially all of the work up to this point, he is naturally inclined to favor the highest possible price and lowest spread with which he feels the issue can be successfully marketed. The only compensation for his efforts will come from a piece of business successfully bought and sold, because he bills the group, if unsuccessful, only for out-of-pocket expense. After the bids have been opened and the winning bid chosen, the securities are awarded to this group, subject to clearance by the SEC. From this point, the procedure is very similar to that described on pages 232 *et seq.* for a negotiated deal.

When an issue is bought, the manager signs the purchase contract, approves the final price amendment, and handles the sale of the securities as he would in a negotiated deal. The number of competing groups ranges all the way from two to about fifteen, depending on the size and popularity of the issue. There is thus much wasted effort and expense inherent in this phase of the investment banking business, particularly for managers of bidding accounts.

Functions of Investment Banking Relating to Outstanding Securities

Functions subordinate to capital formation. The primary function of investment banking in providing capital for new and old businesses was fully covered in the first part of this chapter. We shall cover in the next chapter the function of acting as intermediary in private placement of security issues.

At page 229 we indicated that investment banking had other functions subordinate to capital formation. These additional functions, most of which are associated with outstanding securities and securities markets, include: (1) secondary distribution of large blocks of outstanding securities, (2) acting as broker or dealer, (3) offering security advice and portfolio management, (4) security substitution, and (5) allied services. Each of these functions is explained below. Some of the larger underwriting houses carry on all of these functions in completely integrated organizations; others perform some but not all of them, depending upon their size, opportunities, and preferences.

Secondary distribution of large blocks of outstanding securities. The function of distributing large blocks of outstanding securities, which is second in importance to the capital formation function, includes primarily (1) transfer of ownership of outstanding securities,

(2) transfer of part or all of the ownership of closely-held businesses, and (3) transfer of ownership from a corporate holder to another corporate owner or to individual investors.

Large blocks of securities are often outstanding in the hands of estates, trust and investment companies, governments, corporate officers, and others. The transfer of ownership of such blocks is effected by brokers on national security exchanges, or by "special offerings" and "secondary distributions" when such securities are listed, and by over-the-counter dealers and brokers when such securities are unlisted. These institutions are described in detail in the following chapter. Their work in liquidating blocks of securities will be described there. It is important to realize here, however, that the existence of specialized facilities for the efficient transfer of existing securities is an integral part of the machinery of capital formation.

The transfer of ownership in private or closely-held businesses to whole or part public ownership is becoming an increasingly important function of investment banking. In the last few years a large proportion of the issues distributed to the public has been of this "sell out" or "partial sell out" type, not involving the raising of new capital. One of the principal reasons for this trend is the difficulty of meeting inheritance taxes by estates whose principal asset is in non-marketable securities of a family enterprise. In order that such estates may be in a position to meet taxes, the owner or his executors must often make a public sale of holdings to provide required cash reserves. In some instances, the owner of a closely-held business desires to have a public market for his company's securities during his lifetime, to afford ready market appraisal of his remaining holdings upon his death, to afford his heirs a marketable legacy, or to establish the availability of a market for further dispositions from the estate as may be required to meet inheritance tax claims and the like.

The transfer of ownership from one corporate holder to another, resulting in an acquisition or merger, is often negotiated and financed by investment bankers. Not only is the basis for exchange of securities or cash, or both, frequently calculated and recommended by bankers in the light of their knowledge of relative security values, but if new financing is required they may be called in to effect a public distribution of the securities issued to raise the needed cash.

The transfer of ownership of a subsidiary's securities from a holding company to private investors has taken place on a major scale as the result of the Public Utility Holding Company Act of 1935. The investment banking industry has played an important part in effecting compliance with the divestment rulings promulgated by the Securities and Exchange Commission pursuant to this Federal law. The Act required that public utility holding companies be limited, with certain

exceptions, to operation of a "single integrated public utility system." [11] Compliance with the Act necessitated the disposition of very large blocks of common stocks from almost every major holding company portfolio. In some cases, these securities were distributed or sold pro rata to the holding company's own common stockholders without recourse to investment bankers for general public distribution. In other cases, as required by Rule U-50 of the Securities and Exchange Commission, they were offered to investment bankers at competitive bidding, for resale by them to their clients.[12] A somewhat different procedure was followed by investment bankers in the purchase of 500,000 shares of Pacific Power & Light Company common stock, from American Power and Light Co. for $16,125,000. In this case, the banking group held their purchase in the hope of profitable placement at a later date.

Acting as broker or dealer in the securities markets. The investment banker may be a member of a national or local security exchange acting as a broker or agent or he may be active in the over-the-counter markets. Since the machinery for carrying out the transfer of security ownership through these markets will be covered fully in the following chapter, little more need be said here.

The corporation and individual customer contacts established by large underwriting houses afford considerable opportunity for brokerage business. The solicitation and follow-up of this business are the responsibility of the commission department of the banking house. It operates through the trading department, which carries on the over-the-counter business of the firm and executes commission orders on the exchanges. An active trading department frequently constitutes the "bread and butter" business of the investment banking firm.

Advisory and technical services. Because of its constant contact with securities and their markets and its continual research into the relative values at prevailing markets of individual bonds, preferred stocks, and common stocks, the typical investment banker is well equipped to give investment advice and to manage security portfolios. Some bankers give this advice without charge, as in the instance of security salesmen advising their clients. When an investment banker is also a member of one or more of the national security exchanges and conducts a general brokerage business in addition to his other

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[11] This subject is discussed in Chapter 25, at page 498.

[12] A divestment made by a utility holding company comparatively recently was the sale at competitive bidding of 265,000 shares of Duquesne Light Company common stock by the Standard Shares, Inc. in June, 1957, to a group of investment bankers at $32 515 per share, or a total of $8,616,475. These shares were immediately re-offered to the investing public on a nation-wide basis at $34 per share, affording the bankers a gross profit of $1.485 per share to cover selling expenses and profit.

functions, his representatives in the field give statistical and other factual information to clients.[13]

Some investment bankers, in addition to giving advice on securities in the normal course of their business, as above, also maintain a separate investment advisory department for the purpose of giving investment counsel on a fee basis to medium and larger sized accounts. Such departments compete directly with independent investment counsel organizations, of which there are many. They utilize the research staff, numerous corporation contacts, and market knowledge of the banking organization in managing each individual client's security portfolio to meet his particular investment needs. The apparent conflict of interest in affording independent advice and at the same time being merchandisers of securities is resolved very simply by most bankers offering investment counsel on a fee basis. They agree with clients for whom they act as investment counsel that they will neither recommend nor purchase for the client any security in which they themselves are interested as underwriters, distributors, or owners. If a client desires to have the banker handle his orders to buy and sell securities, which often facilitates portfolio management, the banker agrees that he will act as *agent* only and not as principal. The only exception ordinarily is in the case of municipal and government bonds, where it is customary for the dealer to own the securities he sells; that is, to act as "principal," buying in the market and reselling to the client at a fractionally higher price. An additional protection to the client of the advisory department, intangible but nevertheless important to mention, is the fact that a reputation for integrity is the most precious asset of an investment banker.

Another form of technical service is that offered by the investment banker when he acts as intermediary in the private placement of new security offerings. This service is described at page 246.

Security substitution. The investment banker performs the function of security substitution "in making available as a substitute for outstanding securities a different security which is more acceptable to his customers or to the issuers, and which they find more suitable to their needs." [14] The investment trust is a clear-cut example of security substitution on a large scale. The investment trust, as already explained,[15] secures funds through the sale of its own preferred stock, common stock or certificates, and sometimes bonds. It invests these funds in

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[13] The work of the field representatives is discussed at page 260.

[14] Jules I. Bogen, "Economics of Investment Banking," *Fundamentals of Investment Banking*, sponsored by Investment Bankers Association of America (Englewood Cliffs, N. J.: Prentice-Hall, Inc., 1949), p. 9.

[15] See page 215.

various types of securities and enterprises. Since the securities that the trust sells are backed by a broadly diversified portfolio, they may be far better suited to certain types of investors than any single security would be.

Allied services. There are a number of other services connected with securities that the investment banker performs, with or without charge. He may act as paying agent or transfer agent for a corporation's securities, in such cases charging established fees. He may act as exchange or subscription agent, as a bank or trust company also might, when a corporation makes an offer to its security holders, again charging established rates of compensation. He may also hold securities for his clients in safekeeping, avoiding the burden for them of visits to the safety deposit box. This service, entailing periodic reports of securities held, is usually offered without charge, and if the banker is a member of one of the national exchanges, he observes well-defined regulations covering segregation of clients' securities from his own. Finally, on request, he holds clients' cash awaiting investment, clips bond coupons, obtains payment, and credits the client's account, notifies the client of called bonds and sends them in for payment, exchanges securities pursuant to exchange offers, and receives stock certificates for transfer and sends them out to transfer agents to be transferred on the records. In fact, he offers the myriad of minor services involved in the securities business.

Associations of investment bankers and dealers. The Investment Bankers Association is an organization formed in 1912 to serve those who purchase and sell securities. Its members include underwriting houses, security dealers, and banks. Through its many working committees, it has proved an effective constructive force in the industry. Another organization, the National Association of Securities Dealers, Inc., was established through permissive Federal legislation known as the Maloney Act (1938), which was in fact an amendment of the Securities Exchange Act of 1934. The NASD "is a symbol of self-regulation for industry and an example of co-operation on the part of a business and government to protect the public interest." [16] More will be told about the NASD in the following chapter.

Research Question

From any source, set forth the range of commission paid to investment bankers for securities sold to the public for cash during the latest ten-year period recorded. (Do not include rights financing and private placement.)

[16] Excerpt from booklet published by the Board of Governors of the National Association of Security Dealers, Inc. (September, 1946).

Problem

The Adams Manufacturing Corporation is now offering 1,000,000 shares of common stock to the public through underwriters headed by Jones & Co. The selling price to the public will be \$15, the price to the underwriters \$13.80. There will be four firms in the underwriting group and five in the selling group. The spread will be divided on the basis of 12½ per cent for the management, 33⅓ per cent as underwriting profit, and 54⅙ per cent for selling. At present the shares will be distributed as follows:

	Underwrite	*Sell*
Milo and Co.	250,000 shares	200,000 shares
Abe and Co.	250,000	250,000
Sampson Bros.	250,000	100,000
Brown and Wheeler	250,000	150,000
	1,000,000	700,000

Selling Group:

Jones and White	100,000
Smith and Green	100,000
Jean and Co.	50,000
Alice and Co.	50,000
	300,000

How much would each firm receive on this deal?

ing tens of millions of dollars also has played an important part in the growth of private financing.

Advantages of private placement. The major advantage of private placement to the institutional investor is assurance of obtaining a large amount of one issue without difficulty and much expense; the principal disadvantage is lack of marketability. To the issuer, however, there are a number of advantages to be considered: (1) Expenses are smaller than those involved in a public offering. (2) The financing is effected more quickly than through a public offering because the time generally involved in registering the securities and distributing them is saved. (3) The corporation is more certain of carrying through its financing program at a definite time. (4) A less well known corporation or a situation requiring special explanation may often obtain a better price privately where its strong points can be carefully appraised, than in a general public offering. (5) The credit of the corporation is enhanced because it is generally known that insurance companies buy only the best securities. (6) If securities are closely held, adjustments that may become necessary because of unforeseen contingencies, such as inability to meet sinking fund requirements, interest, or principal payments, are more easily arranged than if the securities are widely distributed.

These advantages far outweigh the one important disadvantage to the corporation—namely, that it foregoes the opportunity, which may arise when securities are publicly held, of effecting savings by purchasing the securities in the open market at a discount to meet sinking fund requirements or to reduce outstanding indebtedness.

How private placement is negotiated with the aid of an investment banker. The usual procedure for a company desiring to raise new capital by means of a private placement is to prepare its audited financial statements and a cash-flow statement. These, together with a statement as to the prospects for the company's business, will provide the basis for a preliminary discussion with the investment banker. The latter will use the financial statements, including a pro forma statement,[1] adjusted to include various additional possible issues to help decide on the most feasible plan of financing. The investment banker's knowledge of the market and his understanding of the type of security that will appeal to institutional investors will also be utilized in formulating the financing plan. Frequently a comparison is prepared to show how the proposed issue would compare with other out-

[1] A pro forma statement is an actual statement adjusted to reflect the changes that would be made upon completion of the financing. Thus, the balance sheet would have the new money added to the cash balance or used to retire debt and the new issue would appear in the capital structure. The income statement would show the changes in interest or dividend requirements involved in servicing the new security.

standing issues of similar companies. Such a study helps to determine the interest or dividend rate and terms of the new issue and is used as a selling aid in approaching prospective purchasers.

After a decision has been reached between the issuer and the investment banker as to the type of issue and the terms, the investment banker will call upon various institutional investors who might be interested in the issue. In this phase of the investment banker's services, he helps the issuer place his securities privately on the best terms possible. For example, one life insurance company might be ready to take the entire issue if there is a slight modification of the proposed terms. A smaller institutional investor might be willing to take half of the issue without modification of terms. If the investment banker can find another purchaser on these terms, he would recommend that the issue be sold to the two smaller buyers rather than to the one large one who would require modification.

Private placement without the aid of investment bankers. If the services of an investment banker are not used, the issuing company's financial officer or officers will prepare the necessary financial statements and general information and then contact institutional investors to present the material for their examination. Usually the institutional investors (chiefly life insurance companies) have staffs that devote a large part of their time to the appraisal of private placement opportunities. The deal may be worked out through negotiations between the issuing company's financial officers and the purchaser's staff, subject to approval by the board of directors of the issuer and the finance committee of the purchaser. This procedure eliminates the fee paid to investment bankers, but this advantage might be offset if the issuing company's officers are not in a position to know which rate and terms it is entitled to obtain. Under such circumstances the issuing company might not obtain as good terms as an underwriter could get for it.

Special circumstances for financing without underwriters. Under certain conditions it has been possible for some companies to finance successfully without using the services of investment bankers. These special circumstances, briefly, are:

1. When a company is in a position to sell stock directly to its employees, direct sale may be undertaken by the company iself.[2]

2. When a company wishes to give its stockholders a large rights value by offering them rights to subscribe for additional securities at a discount from market, underwriting may not be needed. The principles and procedures relating to an offering of rights are discussed in detail beginning at page 247.

3. Where the issuing company has a financial officer or department

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[2] At one time, particularly in the 1920's, some corporations sold stock to their customers, but this practice is not followed now.

that is equipped to contact institutional investors directly, it may be able to place its new securities privately without underwriters.

Selling securities to creditors. Occasionally, creditors of a prosperous concern may be expected to make investments in securities offered by the corporation as a token of appreciation and as a bid for continued patronage. Probably some of the large electrical equipment companies have made investments in customer companies for these reasons. The practice of turning to creditors to purchase securities, however, is usually limited to cases of readjustment, when the stock of the new organization is offered to the creditors of the old company in full settlement of the debts.

Selling securities to employees. Organizations that have made a practice of offering securities to employees have done so primarily to maintain the goodwill of their workers. They have adopted the practice as a preventive of industrial conflict rather than as a means of raising capital. Employee stock ownership became popular in 1919, and from then to 1930 numerous companies, large and small, offered stock to their employees under specific plans. During the depression, employee stockholders found their investments not only shrinking in value but in some cases, where loans had been made to pay for the stock, becoming a liability. Some companies took steps to alleviate the condition, but on the whole the employee stock ownership experience was unfortunate for management and for employees. Most of the plans were dropped, although many who had acquired shares continued to own them.

Interest in employee stock ownership was revived during the post-World War II prosperity. Some companies restored their old plans on a more conservative basis and others introduced plans for the first time.

Employee stock ownership plans vary from company to company regarding conditions under which employees may participate, limits of purchase, price at which the stock is sold, method of payment, and rights of resale or cancellation of subscription.

Use of Stock Rights in Distribution of New Securities

Stock offerings to existing stockholders. Corporations in need of additional equity capital sometimes offer their new issues of common stock to their present stockholders voluntarily because they can market the issue most economically in this way. When this is done, an inducement is given to the present stockholders to purchase the stock by offering it to them at a price below the current market price for the corporation's outstanding shares. For this reason, such offerings are known as privileged subscriptions. Each stockholder is given one "right" for each share of stock owned. This right represents an option

to purchase the new shares of stock at the ratio fixed by the corporation. For example, if the corporation sets a one-for-two ratio, the right represents an option to buy one new share for each two shares held (or one-half share for each whole share held). In other words, two rights, plus the price of the share, are required to acquire one new share. In a one-for-three offering, three rights would be required for the privileged subscription. A date of record is set for determining who is entitled to rights, usually the date when the registration statement is expected to become effective. Another date is set for the expiration of the right. Warrants evidencing the rights are mailed to all the stockholders of record at the close of business on the record date. The holders of the rights may exercise them or sell them.

More frequently, however, an offering of new securities is made to existing stockholders, not voluntarily but because the corporation is required by law to recognize the present stockholders' pre-emptive rights. The legal aspects of pre-emptive rights will be explained briefly.

Stockholders' pre-emptive rights. To preserve each stockholder's proportionate voting power in the corporation and to protect the value of the ownership represented by his shares, the common law gives each stockholder a pre-emptive right to subscribe to additional issues of stock. Under this rule, stockholders must be permitted to subscribe to such proportion of the additional stock as the number of shares already owned bears to the total number of shares previously issued. Thus, if a corporation with $50,000 par value common stock outstanding decides to increase its capital stock 50 per cent, *A*, a stockholder with $5,000 par value of stock, is entitled to subscribe to 50 per cent of his holdings, or $2,500 of the new stock. Stockholders with pre-emptive rights must be offered the stock at a price not greater than that at which the shares not taken by them are to be offered to the public.

Many of the state corporation laws prescribe the extent and nature of the pre-emptive rights. In most of the states it is permissible for the charter to deny pre-emptive rights to stockholders. Thus, many corporations have created preferred stock issues without pre-emptive rights, and some companies have preferred and common stock without such rights.[3] In some instances, corporations have amended their certificates of incorporation to remove the pre-emptive rights when it appeared that a new issue could be marketed more successfully through underwriters.[4]

[3] For example, Aluminum Company of America, Armstrong Cork, Dow Chemical, Sperry Rand, and United States Steel.

[4] Stockholders of Columbia Gas System, Inc., authorized amendment of its certificate of incorporation in 1950 to permit sale of additional common stock at competitive bidding without first offering subscription rights to present shareholders after an unsuccessful experience with an offering to shareholders in 1949. See note 7.

Principles behind pre-emptive rights. The pre-emptive right is based upon two principles: (1) that existing stockholders must be given an opportunity to keep proportionate control; and (2) that the equities of the stockholders in the surplus and earnings of the corporation must be preserved.

Effect of sale of stock on control. The proportionate control of the old stockholders will be disturbed unless new stock, when about to be issued, is first offered to them. Suppose *A*, *B*, and *C* own stock in the *X* company in the following proportion: 100 shares, 200 shares, 300 shares. If the directors issue 12 shares to *D*, a friend of *C*, the latter will control a clear majority, and if ordinary voting prevails, *C* may deprive *A* and *B* of representation on the board of directors. Under the rule of stockholders' rights to new issues, however, the 12 shares would have to be offered to *A*, *B*, and *C* in proportion to their holdings, and *A* and *B* would have the right to maintain their proportionate control by taking 2 shares and 4 shares respectively, leaving 6 for *C*.

This principle has greater application to the relatively small and closely held corporation than to the large corporations in which no stockholder owns a large proportion of the stock.

Effect of sale of stock on surplus. The relation of new stock issues to the old stockholders' respective interests in the surplus can best be explained with the aid of the accompanying balance sheet.

A COMPANY

Assets		*Liabilities and Capital*	
Total	$1,500,000	Debts	$ 200,000
		Capital Stock ...	1,000,000
		Surplus	300,000

The net value of the *A* company to its stockholders is the value of the assets less the amount of debts,[5] that is, $1,300,000. If we assume that the shares have a par value of $100, then the book value of each share of the 10,000 shares outstanding of *A* company will be $130. If $2,000,000 of new stock is sold at par, the net value of the assets will be $3,300,000 and the value of each of the 30,000 shares, therefore, will be $110. In this case the new stockholders will get a share worth $110 for $100, and the old stockholders will see their shares diminish in value from $130 to $110 each. If, however, each old stockholder bought shares of new stock in proportion to his old

[5] Since the total of liabilities, capital stock, and surplus is equal to the total of assets, we may express the above formula by taking the debts from this total. If we do so in the above example, it becomes clear that the net value of a corporate property to its owners is the sum of the capital stock and the surplus.

holdings, he would get two new shares for each old one, since the stock of the company was increased by two shares for each old share. The $20 of loss suffered on the old stock would be made up by the $10 gained on each of the two new shares.[6]

Issues of stock to which pre-emptive rights apply. A corporation may issue additional shares for different reasons and under different circumstances, which may raise questions as to whether the pre-emptive rights of the existing stockholders must be recognized. The courts have said that the application of the rule of pre-emptive rights must be consistent with the object for which the stock is to be issued. They have therefore held that the pre-emptive right does not apply when additional stock is issued for property, to wipe out a debt or claim against the corporation, and to secure a loan.

The problem of applying the principle of pre-emptive rights is complicated by the existence in modern times of various classes of preferred stocks, some with voting power and some without, some redeemable and others not, some convertible into one class of securities and others into another. Directors should consider how each class of stock will be affected by the issuance of additional stock of the kind agreed upon and should act in good faith in the interest of the shareholders in offering the shares, having in mind the rights of stockholders to proportionate interests in surplus and proportionate voting control. Applying this rule, stock which has no voting rights and is non-participating would not be entitled to subscribe to new issues of stock.

Mechanics of rights. No matter how the rights originate, in current practice each stockholder entitled to them receives a warrant made out for the exact number of rights to which he is entitled. Thus, if each stockholder must own five shares to subscribe to one new share, a stockholder owning twenty-two shares would receive a warrant for twenty-two rights and would sell two of his rights or would buy three additional rights.

Shareholders are not always aware that plans are being formulated for the issuance of rights. Unless authorization for increasing the capitalization must be obtained by amending the corporate charter, in which case the stockholders must vote on the change, the directors alone decide on the financing. Sooner or later, however, the shareholders are notified by letter of their claims to rights. They are informed of the terms on which the new stock is being offered, the purpose for which funds are being raised, and the period during which the subscription privilege may be exercised. This period is usually

[6] If the stock were sold at $130 a share instead of at par, the old stockholders would not suffer even if they were not given an opportunity to subscribe to the new shares. But there would still be the question of unbalanced control that was explained in the previous section.

from ten days to three weeks, sufficient time to permit present stockholders to study the terms of the offering and make their decision. The warrant sent with the notice specifies on its face the amount to which the shareholder may subscribe and the terms of the subscription; the reverse side contains the subscription blank and a form for assignment in case of transfer. By negotiating with the treasurer of the company, who is generally the officer in charge of all transactions concerning the rights, the shareholder, if he desires to use only part of the subscription privilege, may have his warrant exchanged for other warrants of the same aggregate principal amount, the separate warrants being disposed of as he may choose.

Disposition of rights. If the shareholder has not the means to purchase more of the stock, or does not care to exercise his privilege, he may sell his rights. The existence of a market for the rights is dependent upon whether the privilege has a market value. This value arises when the price at which the new stock is offered to the shareholder is lower than the market price of the stock. Should the price of the stock fall, the value of the right will diminish proportionately until it is wiped out when the stock ceases to sell at a premium above the subscription price.[7]

The value of the rights is not reflected in the price of the stock until the stock on which the rights are to be issued becomes stock "ex-rights." This usually happens on the third day, or such other day as the Stock Exchange rules specify, before the record date.[8] At this

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[7] This happened to many rights that were caught in the stock market crash in 1929. In some instances the companies withdrew their stock offers and returned the subscriptions that had been received. For example, an offering of stock was made by the North American Company in September, 1929, at $100 on a one-for-ten basis. At one time after the offer, the stock was selling at 170 and the rights reached a value of 7⅛. The number of rights bought and sold totaled 1,180,450. With the crash, the value of the right fell to 1/64 of a dollar and later its value disappeared entirely. The price of the stock fell to $70, or $30 less than the subscription price for new stock. As a result of this situation, the company withdrew its stock offer and returned the subscriptions that had been received. With the cancellation of the offer, the rights really had no existence. The transactions in rights, however, were not canceled, and those who had purchased them with the purpose of taking up the stock suffered the loss of whatever they had paid for the rights.

In May, 1949, Columbia Gas System, Inc. offered 1,345,300 common shares to existing stockholders at $10 per share. The quoted value of the company's common shares was well above the $10 price during the early part of the offering period. Then the stock market dropped generally and the company's shares fell in value below the price named in the rights. As a result, 304,998 of the 1,345,300 shares offered were not taken by stockholders or purchasers of rights. Since the company needed the proceeds of these shares to finance construction, they were subsequently sold with SEC permission at competitive bidding to underwriters at $12.253 per share and Columbia received full payment within three days. As a result of this experience, in 1950 the company asked stockholders to approve an amendment of the certificate of incorporation to remove the pre-emptive rights of the common stockholders. See note 4.

[8] That is, the day set by the company for closing its books, so that it may make up its list of stockholders and determine the number of rights to which each stockholder is entitled.

time the stock is bought and sold without the rights and the actual subscription warrants are bought and sold separately from the stock. Separate trading in rights continues until the expiration of the subscription period, when, if the rights are not exercised, they cease to have value.[9] During the period when trading in the stock can be arranged with rights (with due-bills or "cum rights"), there is often "when issued" trading in the warrants.

The issuance of rights which have a low value is often seized upon by speculators as an occasion for making short sales of stock and protecting the sales by the purchase of rights. If the stock moves down, the speculator profits to the full extent of the drop, less the cost of the rights and the commission, whereas if the stock moves up, however high, by exercising his subscription privilege the speculator limits his losses to the cost of rights, including the broker's commission.

Formula for finding the theoretical value of a right. As indicated in the preceding paragraphs, stock is traded "with rights" until a certain date and then is traded ex-rights. In order for the present stockholder, and also the speculator, to determine upon a course of action, it is necessary for him to know the value of a right. The theoretical value of a right can be found by the use of the following formula:

$$\frac{M - S}{R + 1} = \text{Value of a right.}$$

M represents the market value of the old stock; S, the subscription price of the new stock. R is the ratio of the number of old shares to the number of new shares to be issued. This ratio represents the number of rights that will be needed for the purchase of each new share. For simplicity, therefore, we may say that R is the number of rights necessary to purchase one share of the new stock. To this number must be added one (1), representing the right that attaches to each share of stock before it is sold ex-rights. In other words, that additional right has not yet become a separate entity but is still attached to the share of stock.

For example, suppose $800,000 of stock with a market value of

[9] On almost every offering of stocks and bonds made to stockholders, large amounts of money are lost by stockholders who fail to sell their rights or exercise the subscription privilege because of carelessness, ignorance, distrust, or plain inertia. In 1949, on an offering of $394,372,900 of convertible debentures, it was estimated that over $600,000 was lost in this way. Some of the utilities have offered dealers a special fee for their aid in getting stockholders to exercise their subscription rights. For example, in an offering of Missouri Utilities stock, the company paid dealers 25 cents a share for obtaining the exercise of rights and in addition 40 cents per share on any number of shares above the amount of stock to which the stockholders were entitled to subscribe. With dealer co-operation stimulated by this extra fee, Missouri Utilities sold 98.5 per cent of the shares offered to existing stockholders. The balance of the issue was taken by a stand-by underwriting group.

$125 per share ($100 par), is being increased to $1,000,000 or by 2,000 shares and the stock is offered at $110 to the old stockholders. The ratio of old stock to new, then, is 4 to 1 (8,000 to 2,000) which means 4 rights will be required to buy one new share. Substituting figures in the formula, we have:

$$\frac{\$125 - \$100}{4 + 1} = \$5, \text{ value of a right.}$$

The value of a new share is theoretically the price which the old shareholders will pay plus the cost of as many rights as are needed to purchase one new share, or, expressed differently, the market price of the old stock less the value of a right. In the above example, subscription to the stock required $100 plus the cost of four rights, $20, making a total of $120.

Practical effect of rights on price of stock. Theoretically, it is clear that the issue of new securities to which rights attach demands a downward revision of the market price. Practically, however, this adjustment is often nullified or possibly emphasized by the many other elements that determine price in the open market. New financing might be favorably interpreted as evidence of an increased volume of business and a sign of healthy growth. Interest in the company produced by press publicity and a favorable statement of conditions, with increase of confidence in the ability of the company to maintain dividends on the increased capitalization, might provoke an improved demand and consequently a higher price. Quick assimilation of a new issue might strengthen the position of the stock, or a generally bullish market might more than offset the normal downward adjustment. On the other hand, a reverse condition, which is just as likely to prevail, may cause a drop in the stock far below what the "right" adjustment would seem to warrant. The downward tendency, which theoretically should set in, might not be attributed by the shareholders to a natural adjustment, and the skepticism of the few who did not understand the situation might cause some unloading that would push the price down lower than the level to which theoretically it should fall. The offering for sale of any large amounts of stock will have the effect of depressing values, and if speculators, anticipating a drop in the price, should sell short in quantities, their own actions might result in driving the price downward. The entire situation is one governed by the laws of supply and demand, and the price will go up or down depending upon whether the amount desired by purchasers is greater or less than the amount offered for sale.

Observation has shown that in most cases the old stock and the rights attain their highest value at the beginning of the subscription period, and decline materially in value toward the end of the term.

The causes of this movement are again governed by the laws of supply and demand. At the beginning of the period the increase in the supply of the stock does not make itself felt in the market; as the new shares are bought and sold in anticipation of their issue, the increase in the number of shares depresses the price of the old stock and of the rights. Another reason is that many stockholders postpone the sale of their rights to the last minute, thus bringing into the market a supply of rights at a time when there is little demand for them for the purpose of "evening up" odd lots, because those seeking additional rights for that purpose purchased them early in the period.

Standby underwriting of offerings to stockholders. To protect itself against failure to sell all of the additional stock offered to existing stockholders—that is, the failure of all of the stock rights being exercised—a corporation may decide to make use of a standby agreement with investment bankers. A standby agreement, as previously explained, is one by which the bankers bind themselves to purchase all of the securities that the issuer is unable to sell by another method of distribution. The standby agreement assures the corporation of complete sale of the security offering; the banker assumes the problem of marketing the unsold balance. Not all privileged stock subscriptions, however, are protected by standby agreements.

The only real difference between standby underwriting and a straight negotiated purchase and sale is that the banker must wait until the end of the subscription period before he can make a regular public offering of the unsubscribed portion. Sometimes the entire issue is subscribed and the banker has no balance to sell.

Generally, the underwriters' compensation under standby agreements is divided into two parts: (1) the *standby fee,* often around 2 per cent of the entire issue, and (2) the *takedown fee,* which is a stated amount per unit of the securities that the banker must take and merchandise. The takedown fee is sometimes a single amount per unit on all securities taken, or varying amounts, depending upon the percentage of the offering left unsold for the bankers to take. In practice, there is considerable variation in methods used. In some cases the banker simply charges a single over-all fee, estimating what percentage of the issue will be left for him to sell and then arriving at a total compensation for standby and takedown based on the amount of the issue he thinks he will have to merchandise. Under some agreements special compensation is offered to underwriters and dealers for soliciting subscriptions. In most other respects the underwriting procedure is much the same in standby underwriting as in a negotiated straight purchase and sale.

Research Question

From Moody's *Manual of Investments,* or any other source, summarize the employees' stock plan of the American Telephone and Telegraph Company.

Problem

Mr. Edwards, Mr. Nelson, and Mr. Rogers each own 1,000,000 shares in the ENR Corporation. The stock at the present time has no established value as it is not listed and has not sold over-the-counter in the last ten years. The corporation has built up a strong cash position over the years, has an excellent name and distribution outlets. The most recent balance sheet is as follows:

Cash	$ 5,000,000	Accounts payable	$ 1,000,000
U. S. Government securities	11,000,000	Capital stock 3,000,000 shares ($10 par)	30,000,000
Accounts receivable	5,000,000	Earned surplus	20,000,000
Inventory	10,000,000		
Fixed assets	20,000,000		
	$51,000,000		$51,000,000

Earnings are about 4 per cent on invested capital. Competitor corporations are earning about 8 to 10 per cent on invested capital, chiefly because they have less cash and securities. If you were in the owners' position, and wanted to diversify your investment, would you favor a public sale of stock by a secondary distribution or a sale of the stock to a competitor?

CHAPTER 14

Securities Markets and Their Regulation

Nature of the national securities market. In the preceding chapters we explained how new issues of securities got into the hands of security buyers and investors. The primary markets, in other words, were completely covered. Here we are concerned with secondary distribution—that is, how the existence of a national securities market makes it possible for owners of securities to convert their holdings into cash and for people with cash to buy securities from present owners. The importance of the markets cannot be appreciated unless one realizes that without them public distribution of government and corporate securities would be virtually impossible, and our large-scale, efficient economy could not exist.

The national securities market consists of the organized stock exchanges and their member firms, the over-the-counter brokers and dealers, and the investing public which they serve. The stock exchanges are organized auction markets where buyers and sellers come together, through their brokers, to effect transactions in securities admitted to listing on the exchange and in unlisted securities for which a market is maintained. The over-the-counter market is a negotiation market maintained by thousands of dealers and brokers all over the nation who buy and sell any recognized security, whether listed on an exchange or not. The over-the-counter brokers and dealers buy and sell Federal, state, and municipal obligations, obligations of foreign governments, and stocks and bonds of domestic and alien corporations. There are no requirements for admission to trading in the over-the-counter market other than the choices of the dealers and investors.

New York City is the focal point of the national market, although there are regional exchanges and over-the-counter markets for locally popular securities in the major cities. The various segments of the market are closely co-ordinated through branch offices and correspondent firms of the larger brokerage and dealer houses. An investor anywhere in the country can consummate a trade at any time during market hours in an amount and at a price determined by the free competitive interplay of supply and demand influences from the entire nation.

Economic function of securities market. From the economic viewpoint, the market performs several important functions. It provides an easily accessible, constantly available means whereby persons with cash may convert it into securities, and those with securities may readily obtain cash for them. This liquidity feature enhances the value of securities and facilitates their use as collateral for loans. By reference to the market, companies intending to obtain funds through new issues may ascertain what types of securities are most likely to be salable and the general range of prices they may reasonably expect to receive for them. Furthermore, the existence of a market enables wider distribution of primary issues. Also, companies whose securities have a ready market become known through the publicity given to quotations, annual reports, and other news of interest to investors. Such publicity may constitute a valuable advertising medium for the company's products.

The function of the securities market in connection with the distribution of new issues was discussed in the preceding chapter.

Organization of stock exchanges. A stock exchange is a voluntary association or an incorporated organization, usually directed by a Board of Governors elected by its members. The typical exchange is administered in part by a paid staff and in part by elected and appointed committees of members. Memberships are limited in number, and, unless new ones are created, are acquired only by purchase from an existing member or by transfer upon his death. Memberships are called "seats" and have a monetary value. The price at which a seat is sold is negotiated between the buyer and the seller. This price fluctuates with the activity in the stock market and with the prospects of making profit through use of the membership in trading on the exchange. Before a purchaser of a seat is admitted to the privileges of membership, the exchange conducts an investigation into the character, background, and financial resources of the prospective member. He must then be elected, pay an initiation fee, and annual dues.

The New York Stock Exchange is the most widely known and most important, by far, of all the exchanges in this country. Exchanges outside of New York usually account for less than 5 per cent of the

total annual trading done. Of the more than 95 per cent of transactions consummated each year in New York, usually all but 5 to 10 per cent is done on the New York Stock Exchange, with the American Stock Exchange accounting for the remainder. The description of the operations of the New York Stock Exchange that is given below may be considered as typical of the way in which all exchanges function.

The New York Stock Exchange. This exchange was founded in 1792 as a voluntary, unincorporated association. Until 1938 it was governed by a nonsalaried member elected as president, and a Board of Governors. Much of its work was done by committees of members. In accordance with its constitution and by-laws, the exchange provided housing and facilities for the market, standardized "street" practices, and adopted rules and procedures intended to maintain the integrity of members' business conduct and to discipline those who did not conform to these salutary controls. The exchange has always been able to meet its growing responsibilities with reasonable adaptations of its regulations. However, inquiries made after the 1929 crash proved that the exchange had not provided rules of sufficient breadth to meet the situation at that time. Furthermore, enforcement by the Business Conduct Committee was much too lenient even when the rules were adequate.

In 1937 the Securities and Exchange Commission requested the New York Stock Exchange to present a plan of reorganization which would make it possible for that institution to discharge its responsibilities more effectively. In 1938 such a plan, providing for reorganization of the exchange and a modern administrative organization, was adopted with Commission approval. The number of Governors was reduced, representatives of the public were added to the Board, and a salaried president took office. Standing committees were greatly reduced in number and paid executive officers took over their functions. Controls to assure the financial reliability of members were strengthened. In addition, provision was made to bring under exchange jurisdiction the general partners of member firms when they held no seats of their own. This was accomplished by classifying them as "allied members." As such, they became directly subject to the disciplinary authority of the exchange. Prior to the adoption of this classification, members of the exchange were held responsible for the conduct of their non-member partners. Allied memberships confer no voting rights in the management of the exchange and have no salable value. They are, however, now represented on the Board of Governors.

Listing of securities. For the protection of the public and the maintenance of investor confidence, the New York Stock Exchange permits trading only in securities that have been listed on the exchange. To be listed, certain requirements and procedures of the exchange must be

met by the corporation whose securities are to be listed. For example, it must prove successful operation over a period of years, have a minimum total value of shares outstanding, and have net earnings after taxes of not less than a designated amount. It must supply facts and publish annual financial reports concerning assets and earnings so that investors may have adequate information on the basis of which to make appraisals. Since the creation of the Securities and Exchange Commission, listing requirements are re-enforced by Commission regulations concerning the amount of public disclosure of facts about corporate officers deemed necessary. In addition, to be eligible for listing privileges, the security must have wide distribution. This requirement is to assure a broad base for its market and to free it from the possibility of domination by an individual or a small group of speculators.

The specific listing requirements vary with changes in economic conditions, but the tendency is always toward more rigid rather than relaxed standards. Any corporation that can qualify is eligible to file an application for listing. This document and the supporting data are examined by competent personnel of the exchange, who recommend appropriate action for consideration of the Board of Governors. The Board may deny listing even to a company that has received favorable recommendations from the examiners.

Delisting of securities. Once granted, the listing of a security remains effective until the security is delisted, in accordance with procedures established to protect investor interest. Delisting may be brought about in one of several ways. For example, the exchange may certify that public interest has terminated because the issue has been redeemed in full or exchanged for other issues in connection with a merger or consolidation. The issuer may also apply for delisting for a number of reasons. It may allege, for example, that the security no longer has any value; or it may seek delisting because it believes that the market price of the security on the exchange consistently fails to approximate reasonable values and that trading in the over-the-counter market would give more realistic prices. The Board of Governors, with approval of the Securities and Exchange Commission, may delist any security with or without concurrence of the issuer. This action is usually taken because of failure of the corporation to comply faithfully with exchange regulations.

Advantages of listing. Normally, listing lends prestige to a stock and widens its market. This in turn enhances its liquidity and raises its value for collateral purposes. The fact that the exchange compels the issuer to comply with high standards creates public confidence. As already indicated, publicity derived from trading on the exchange and from the interest of financial publications in these trades is a distinct advantage to listed companies. Nevertheless, many corporations

qualified to list their securities choose not to do so. They hesitate to subject themselves to meeting the Securities and Exchange Commission requirements when the over-the-counter market is providing an adequate means for transfers of their issues among investors.

Unlisted securities. On some exchanges, notably the American Stock Exchange, trading privileges are granted on a so-called "unlisted" basis upon application of an exchange member. The corporation whose security is admitted to this privilege need not be consulted nor need it make any application. Under these circumstances it is under no obligation to furnish information or to meet any standard requirements. Whatever information is furnished is received from the broker who applies for the unlisted status to be approved. However, unlisted trading privileges are regulated under the Securities Exchange Act of 1934.

Member firms. A corporation cannot be a member of an exchange, but many exchange members represent partnership firms called brokerage or commission houses. Some of these are very large; they employ numerous registered representatives and have many branch offices connected by private wire systems. Others are small, have only a single office, and serve a clientele in a more limited area. Still others, such as odd-lot houses, serve other brokers in special capacities.

Registered representatives, formerly called "customers' men," are salesmen who service customers' accounts, as do also some of the partners of the firm. Since these persons are in contact with investors, they bear a large part of the responsibility for compliance with the fair and equitable practices incorporated into the regulations of the exchange and of the Securities and Exchange Commission. In recognition of this fact, the exchange has imposed standards for, and tests of, their qualifications.

Brokers, when they are acting only in the capacity of brokers, have no securities to sell, and therefore their representatives must sell the firm's services instead. It is incumbent upon these representatives to know well the investment objectives of the individual investors they serve and the nature of each investor's portfolio. They must be familiar with his investment program and have some knowledge of the rate of accumulation of the investor's funds as well as his other resources. As markets fluctuate or indicate well defined trends, they must be prepared to make suggestions to the investor concerning advantageous purchases or elimination and replacement of parts of his portfolio. A typical brokerage function does not stress advice as much as information; the broker allows the client to take the responsibility for making up his mind to buy or sell. Nevertheless, the more successfully the representative can make sound suggestions, well supported by factual

arguments, the more business he can produce. Hence, the selling job is an aggressive one calling for real ability and mature judgment.

Classification of member activities on the exchange. The members of the New York Stock Exchange are brokers with specialized activities. They may act as:

1. Floor brokers.
2. Odd-lot dealers.
3. Specialists.
4. Floor traders.

Floor brokers. There are two kinds of floor brokers: the members of brokerage firms who execute their own customers' orders on the floor of the exchange, and the so-called "two-dollar brokers." The latter serve commission house representatives who receive a customer's order at a time when they are personally too busy to execute it. The two-dollar brokers execute the orders for the busy brokers. The name "two-dollar broker" originated because that was the sum he got for his services. His fee today is much larger, but the name still remains in use.

Odd-lot dealers. Stocks are customarily traded in units of 100 shares, although some stocks are authorized for trading in units of 10 shares. If a broker's order is for less than a "round-lot," he utilizes the services of another colleague, called the "odd-lot dealer." This is an individual who buys and sells shares in less than trading-unit amounts. He purchases fractional amounts and combines them into trading units, or, conversely, buys units and sells them in smaller amounts. The fee of the odd-lot dealer is added to the price of the security, as is the fee of the commission house that requested execution of the order for the customer. Naturally, the latter pays the differential.

Specialists. The specialist is an exchange member who maintains a book of bids or offers in securities in which he specializes. These bids and offers are at prices near the market, specified by customers of commission houses who refer orders to him for execution. As markets rise and fall and specified prices come into line with current prices, he buys and sells these securities both as broker and for his own account. He executes orders as principal, in the absence of buyers and sellers, to offset orders on his books, whenever it is necessary for him to do so in order to make an orderly market. There is at least one specialist in every security sold on the stock exchange.

Floor traders. Some members of the exchange trade solely for their own accounts. They are known as "floor traders." The floor trader is a professional speculator who makes his profits by taking advantage of short-term price changes in markets. There are also members who

buy and sell for investment purposes. They make use of their membership privileges to act for their own account, thus saving substantial sums in commissions.

Execution of an order. An order to buy or sell securities on the exchange is received at the commission house and transmitted to the stock exchange member of the firm who is on the floor of the exchange. Upon receipt of the order, he goes to the post, a U-shaped desk in the trading room, where the security in question is traded. At the post an indicator informs the member of the last sales price for the security, and a plus or minus symbol indicates to him whether or not this price is above or below the last previous sales price. Around the post other exchange members are busy submitting bids and making offers. Because sales are consummated and prices established by means of matching bids and offers on a first-come, first-served basis, the best bid seeking the best offer and vice versa, the exchange market is said to be an auction market.

If the customer's order is to be executed "at the market," the broker orally closes a contract with the other member or members making the best offer or offers, if his authority is to buy. If it is to sell, he sells to those making the best bid or bids. A customer's order may be to buy or sell at a specified price. This is known as a "limit order." If the market is not within the range of the broker's authorization, he must await an opportunity to close a contract when price fluctuations make it possible to do so. Limit orders are good only for the day on which they are given, unless otherwise specified. If the order is to be good indefinitely, it is referred to as GTC, "good till cancelled," or an "open order." Still another type of future order is the "stop-loss," which authorizes the broker to sell when the security price declines to the designated point. The investor thus limits the extent of his loss.

Confirmation of orders. The sales contract, as has been noted, is closed orally between brokers on the floor of the exchange. Each party makes a written memorandum which is transmitted to the brokerage house he represents. A confirmation is sent to the respective customers. One copy of the record is dispatched at once to the ticker room of the exchange. From there, information concerning the sale is sent out on the ticker tape for the benefit of investors in all parts of the country.

The over-the-counter market. The over-the-counter market consists of a large number of dealers and brokers throughout the nation who, for their own account and as agents for customers, buy and sell securities among themselves and with the public, without the use of any exchange facilities and with no publicity concerning individual sales. Many stock exchange member firms also operate in the over-

the-counter market. Some of the participants in this market are also active as underwriters of new issues.

The over-the-counter market is the principal one for Federal, state, and municipal bonds, and for the majority of public utility, railroad, industrial, and foreign bonds, and for bank and insurance company stocks. The volume of bond trading on exchanges is relatively small when compared with that of the dealers who make up the over-the-counter market. Transactions in any security that has a determinable value may be negotiated. Widely held and actively traded issues of nationally known companies usually find many dealers in competition continuously making bids for, and offers of, moderate amounts. Less well known or less widely distributed and relatively inactive issues are also bought and sold. However, as a rule, fewer dealers *make a market* in them, that is, stand ready to buy or sell them. It occasionally takes time and some effort to find a bid or an offer at any particular moment. Given a reasonable amount of "floating supply" of an issue, and more or less continuous investor interest, it is always possible to create or maintain a continuous market for the security over the counter.

Trading and sales procedures of participants in this market, to the extent that they are not regulated by laws, have always been governed by "street" customs and trade practices evolved over the years the market has existed. Most of them have now been codified by the National Association of Securities Dealers, Inc.

The focal point of the over-the-counter market for the great majority of the thousands of securities traded is New York City. However, some issues that enjoy special popularity in communities where the issuing company is a large employer or supplier of a commodity or service, or where it purchases the bulk of its raw materials, are traded principally by local dealers. The nucleus of the market is composed of many large houses that make markets in many securities, continuously and in volume, and a number of smaller houses that do the same for one type of issue or selected issues. The rest of the market consists of dealers who, as principals, buy and sell whatever securities are of interest to their customers or themselves at any period of time.

Making a market over the counter. Often, there are security issues for which the dealer identifies himself as "making a market." Making a market means that the dealer, for his own account, is ready and willing to buy at his current bid, or to sell at his current offering price, a reasonable amount of the security at any time. The exact number of bonds or shares that he is interested in trading can only be ascertained by negotiation since it is an undisclosed factor of price. As in the case of the exchange market, in the over-the-counter market the best bid seeks out the best offer, and vice versa. But, because there is

no central meeting place where buyers and sellers may come together, prospective buyers must "shop around" for sellers, and prospective sellers for buyers. Since there are no authentic or official published records or continuous reportings of transactions, actual sales prices, or volume of sales for this market, negotiators cannot take these factors into account as can an investor dealing in a listed security.[1]

Over-the-counter bid and offer prices. Prices made by dealers are usually quoted as "bid" and "asked." The lower price stated is the bid, or the price the dealer will pay for the security. The higher price is the offer, or the price at which he will sell it. The difference between the two prices is called the "spread." The size of the spread varies with each class and type of security, and for the same security, from time to time. Since each dealer is constantly and independently determining the prices at which he is willing to do business, he is free at any time to enter into contracts for any amount of the security either on the basis of his quoted prices or at different negotiated prices. He may also quote simultaneously different prices for the same security to different investors or dealers, depending upon whether he believes them to be buyers or sellers. Since he makes his profits on turnover, at any given moment the dealer prefers to be either a buyer or a seller with respect to each of the securities for which he maintains a market. His preference is reflected in the prices he quotes. This preference changes from time to time as market conditions alter and as he closes sales or obtains securities on his bids.

Factors in determining over-the-counter dealer prices. The factors that determine whether any dealer is a buyer or seller vary in number and influence. In general, a dealer will be guided by some or all of the following considerations in pricing securities: (1) The amount of money and credit available to him and his judgment of the extent to which he desires at any time to utilize these to carry his position. (2) The "position he maintains" in the security at the time; that is, whether and to what extent, and over what period, he has been long or short (if he owns the security himself, he is long; if he has sold securities which he does not own, but will acquire later, he is short). (3) The average price at which his position has been obtained. (4) The position he desires to have and the probable cost of acquiring it. (5) The bids and offering prices of his competitors and his judgment of their probable positions. (6) The size and approximate effective prices of potential offerings. (7) The extent of investor demand known to exist at

[1] The National Quotation Service, known as the "sheets," reports bids and offers on stocks and bonds as submitted by more than 1,900 dealers and brokers in all the principal cities in the country. More than 26,000 listings have appeared on some days. A similar service in the municipal field, known as "The Blue List," presents offerings of close to 400 dealers.

or near current prices or which would come into existence at various other prices. (8) His "feel of the market."

The last factor is an intangible element that every successful trader has to a greater or lesser degree. It is based upon his knowledge of market trends and activities, of the customary relationships which prevail between prices of comparable issues, of the effects of national and international economic events, and in particular of these factors as influences affecting prices of each of the securities in which he makes a market. It indicates a quick awareness of short-term movements and the ability to anticipate them.

Not all of the price factors are of equal importance to all dealers nor to the same dealer at all times. The differences in their preferences are reflected in the differences in their prices. Prices may also reflect willingness to buy or sell in large or small quantities. This is something he does not reveal freely except to a customer or to a competitor who requests the information. For the latter to make such a request involves incurring an obligation to complete a trade according to the practices of the trading fraternity. Thus, a quoted price may be good for a very small or a considerable number of bonds or shares. Identical prices of several dealers do not mean, then, that every bid or offer of competitors will hold good for investors who must buy or dispose of sizable blocks of securities.

Variations of spread. Sometimes the dealer indicates his preference to buy or to sell by increasing the spread for a given issue. At other times he does so by quoting only a bid or offering price. In the first instance he will drop his bid while maintaining his offer, indicating less willingness to buy except at the lower price. Or he may maintain his bid and increase his offering price, indicating his willingness to sell only at the higher price. On the other hand, if he wants to buy and not to sell at all, he may make a bid but have no offering price; if, on the contrary, he wishes to sell and not to buy, he will have an offering price, but no bid. Under normal market conditions bid and asked prices are raised and dropped together so that the customary spread is maintained between them.

Any customer who does not wish to accept the quoted prices is free to make a counterbid or counteroffer. This may or may not be accepted. If possible, a price between the two may be settled by negotiation. Once the price has been agreed upon, the contract is closed. It is oral and the only written communications of consequence that pass between the parties are written confirmations sent between dealers or by a dealer to an investor.

Dealers are in almost constant telephone contact with each other and have frequent communication with large investors. Thus, competition and exchange of information tends to keep prices for each secu-

rity generally equated, spreads narrow, and price differentials between geographic areas small.

Profits of the over-the-counter dealer. Dealers derive their profits from the difference between the prices they must pay for securities and the prices at which they are able to sell them. Therefore, the amount of the mark-up in price over the market, or spread between the dealer's buying price and the price which the customer must pay, has a direct relationship to the profits of the dealer. However, the problem of what constitutes a fair mark-up is as yet unsolved. Efforts to provide some form of regulation for this important aspect of the business have been under study for a long time, but no definite rule has been issued. The National Association of Securities Dealers, Inc. has devoted considerable study to this problem and has issued opinions concerning it. The difficulty is to prevent unconscionable mark-ups, yet to be flexible and fair to the trade. As a general rule, any profit is permissible that is not over-reaching. The National Association of Securities Dealers employs a limit of 5 per cent of the selling price as a guide, but in some instances profits beyond the 5 per cent figure may be justified.

The dealers' customers. Contacts between the dealer and his investor customers are made by registered representatives (salesmen of the over-the-counter house) who seek out those investors who they believe would be interested in purchasing a security at a price then current or in an amount then available. The registered representative also keeps in touch with those who might, as markets rise, entertain a bid for their holdings if they consider the current price attractive enough. Unlike the exchange brokers' representatives, these salesmen usually have an actual security to sell at a price. And they are ready to back up, by a purchase, any bid they may make to a customer for his securities. In other respects their duties are similar to those of brokerage house salesmen.

Institutional buyers are important customers of the over-the-counter market. One of the essential services the dealer performs is to buy small amounts of securities from many investors and combine them into blocks large enough to attract institutional buyers. They must also stand ready to bid for large blocks from these customers and to market them in small lots to many investors.

Selling blocks of securities. In the preceding chapter we mentioned that one of the functions of the investment banking system is to transfer ownership of outstanding securities. We shall describe the process of liquidation of large blocks of securities here since it is effected by brokers on the national security exchanges, if the security is listed, or by over-the-counter dealers if the security is unlisted.

Liquidation of blocks of securities owned by estates, trusts, invest-

ment companies, governments, corporations, officers of corporations, and others has always presented special problems. Formerly, when immediate sale was desired and the number of shares exceeded the absorptive powers of the market, there were only two alternative lines of action. Either the sale was completed at depressed prices, or, contrary to the seller's wishes, a large number of small sales was made over a protracted period of time. To overcome the disadvantages of these methods, offerings of blocks were often accompanied, or preceded by, manipulations.

After passage of the Securities Exchange Act with its anti-manipulative provisions and penalties, new methods for orderly liquidation of large blocks of securities, known as "secondary distribution" and "special offerings," were devised.

Under the secondary distribution method, groups of dealers and brokers temporarily associate themselves into a syndicate and offer the block over the counter after the close of the exchange. The price is usually at or near the last sales price on the exchange. Selling effort is utilized and if possible the block is completely sold before opening of business on the exchange the following morning.

To prevent the diversion of business in listed issues from the exchange to the over-the-counter market, exchanges prepare and file plans with the Securities and Exchange Commission providing for liquidation of blocks during normal trading hours through so-called special offerings. Although plans of the various exchanges vary in detail, essentially all provide that special offerings which the market cannot absorb without unduly depressing prices may be made at fixed prices that have reasonable relationship to current market prices. Investors are solicited to buy, and the brokerage commission, larger than customary, is paid by the seller only. Purchasers are informed of all pertinent facts and the offering is well publicized on the ticker tape. Today, either method, a secondary offering or a special offering, may be used to sell large holdings.

Need for Federal regulation of securities markets. In the chapter on security buyers and the regulation of security issues, we discussed the development of public interest in investment and showed how this led to the need for the regulation of the issuance of securities and the regulation of the securities markets. (See page 221.) It might be well to recall here the conditions that prevailed in the boom market of the 1920's. The controls imposed by Federal legislation, which will be discussed here, will thus become more understandable.

Members of the financial community, lured by large profits, abandoned their customary cautions and many of their principles to aid corporations in their endeavors to take advantage of the ease of floating new issues. The extension of liberal credits, the adoption of high pres-

sure sales techniques, and the use of manipulative devices to depress and raise prices contributed to extremely unsound market conditions. Persons in corporate management, and others having access to confidential information—the so-called "insiders"—used their special knowledge to speculate for selfish gains, to the detriment of unadvised investors in the securities of the companies with which the insiders were associated. Unfair and unethical practices became commonplace in every phase of market activities as public participation in the markets grew. As previously indicated, the speculative frenzy culminated, at the height of the public participation, with the crash of 1929 and the enormous economic dislocations that followed in business and in the securities markets.

The United States Senate Committee on Banking and Currency, beginning in 1932, made thorough investigations and held public hearings concerning all aspects of the securities markets and credit uses. The Committee devoted considerable attention to the effects of unregulated practices upon the national credit and the national welfare. The findings of this Committee led Congress to enact the Securities Exchange Act of 1934. The Securities and Exchange Commission was created and charged with the administration and enforcement of this Act and certain others.

Before explaining the ways in which the securities markets are regulated under the Securities Exchange Act of 1934 it would be well to have a clear understanding of the nature of the law and of the functions of the Securities and Exchange Commission.

Nature of the Securities Exchange Act of 1934. To describe the nature of this Act, four points will be covered: (1) the purpose of the law; (2) Federal jurisdiction and what it comprises; (3) investor responsibilities; and (4) security dealers' responsibilities.

Purpose. The purposes of the Act, broadly stated, are to insure maintenance of fair and orderly securities markets and to prevent excessive use of credit for securities transactions. The Act purports to provide, in the public interest, means to prevent abuses and unsocial practices, and to assure free competitive markets.

Federal jurisdiction. Jurisdiction over the organizations, persons, securities, and operations of the markets is conferred upon the Federal government by virtue of the fact that transactions in the national securities markets involve use of the mails and utilize the instrumentalities of interstate commerce. Purely intrastate business in securities is clearly not within the scope of the law and remains subject to state laws.

The rights of supervision and control conferred upon the Commission give it no power to dictate financial policies of corporations or to substitute its judgment for that of any market participant. It cannot

determine what securities shall be offered or sold nor can it influence or determine prices.

Investor responsibilities. Within the limits imposed by honesty and fair dealing, there is no control over the choice of any individual or institutional investor. Decision on whether or not to assume any particular risk rests, as before, with the investor himself. It is assumed that, given ample and correct information, he is capable of ascertaining the risks involved and of making a sound appraisal of his choice of security. However, the Commission has examined realistically the extent to which the average investor is actually competent to make accurate determinations, considering the complexities of modern financial data, even when fully and fairly disclosed. Merely requiring that truthful factual data be made publicly available is not enough. Such information must be both useful and actually used to achieve any sound purpose.

Security dealers' responsibilities. Long before the creation of the Securities and Exchange Commission the fiduciary nature of the relationship between investors, especially the average non-professionals, and their brokers and dealers, had been recognized as characteristic of the securities business. The professional principles of conduct of those in the business acknowledged this fact, but there were many departures from their restraining influence and no means to discipline those who disregarded them.

Reliance upon brokers or dealers is usually induced by the trust and confidence invited and cultivated by them. They hold themselves out to be of superior knowledge and skill in securities matters and thereby represent that investors depending upon that knowledge and skill will be fairly and honestly treated. The unique confidential nature of the relationship requires observance of a much higher standard of ethical conduct than is required of those who bargain truly at arm's length. Professional obligations go much beyond mere closing of a sale. This theme of fiduciary relationship between securities dealers and brokers and the investors who do business with them is a constantly recurring one in the law, the regulations issued by the Commission, and publications and speeches of the Commissioners.

Functions of the Securities and Exchange Commission. The Securities Exchange Act places responsibility upon the Securities and Exchange Commission for several very important functions. We shall consider them under the following categories: regulatory, investigative, and quasi-judicial.

Regulatory functions. The Act sets forth in broad, general terms the powers of the Commission and the nature of the prohibited transactions, leaving it to the Commission itself, within the framework of the Act, to provide specific regulations. These, if they are of general

interest and intended to be permanent, are prepared by the Commission after consideration of the proposals by interested persons most likely to be affected. Upon promulgation they have the force of law. They provide definitions of prohibited activities and impose obligations and duties upon the corporations that issue securities, and upon participants in the financial markets who deal in them. The Commission is often said to have "disclosure powers" under the Act since it regulates largely through its authority to compel full and timely disclosures of factual information. In preparing its rules the Commission endeavors to make them flexible enough to be a danger to unscrupulous and irresponsible persons who might try to take advantage of investors, and yet certain enough for compliance by the many conformists.

Investigative functions. The law empowers the Commission to inspect the books and records of brokers and dealers. Techniques for systematic review of registration statements, reports, and for surveillance of market activities have been developed. On its own initiative, and as a matter of routine, the Commission undertakes to conduct inquiries whenever it believes that any person or group has violated the law or its regulations. Investors who believe that they have been unfairly treated or defrauded may complain to the Commission, which then investigates the facts alleged in the grievance. As an aid to its investigative activities, the Commission has co-operated with state securities commissions, better business bureaus, and chambers of commerce to establish a national clearing house of information. Reports are collected there concerning fraudulent and manipulative transactions and the individuals and firms perpetrating them. To the extent that it is possible, the goal of the Commission's investigative staff, and the policy of the Commission, are to *prevent* abuses and violations rather than to uncover facts about accomplished misdeeds requiring for their correction or punishment the application of statutory remedies.

Quasi-judicial functions. In connection with many phases of its work, the Commission has occasion to hold hearings, publicly if possible, privately if the information to be disclosed is confidential. It seeks to act as a disinterested and impartial referee whose assignment is to insist upon compliance with the rules and regulations and to impose sanctions for violations. Very often the Commission, represented by an interested division, is one of the adverse parties before the examiners. Hearings are held before trial examiners. After trial, the examiner prepares a report for the Commission. When the evidence has been considered, the Commission states its decision and the grounds therefor. An appeal from this decision may be taken by any party to the Federal courts for review. The Commission also reviews certain actions taken by the National Association of Securities Dealers, Inc. Normally, these cases involve expulsions or suspensions of mem-

bers, or denial of membership to an applicant. Lesser disciplinary actions against members of the Association may also be brought up for review.

In addition to its quasi-judicial functions, the Commission often intervenes as a party to civil litigation brought by private persons. It serves at times in the role of *amicus curiae*—literally, "friend of the court." In that event, it files briefs to aid the court in making its decision. Usually it will so act only in cases where judicial construction of one of the acts administered by the Commission is involved and where novel questions of law have been raised.

Means of carrying out purposes of the Act. We shall now consider some of the methods and devices by which the purposes of the Securities Exchange Act of 1934 are carried out. They will be discussed under the following points:

1. Registration of exchanges and control over exchange rules.
2. Comparable regulation of over-the-counter markets.
3. Registration and Federal regulation of securities.
4. Regulation of credit.
5. Trading by insiders.
6. Short-selling.
7. Options.
8. Manipulations and frauds.
9. Regulation and control of dealers and brokers.
10. Sanctions.

Registration of exchanges and control of exchange rules. As a means of bringing exchanges under effective control, they are required either to register with the Commission or to secure exemption on the ground that registration is impractical because of the small volume of business done. Each exchange is obliged to apply for registration and to furnish facts about its organization and activities as well as copies of instruments from which it derives its authority and powers. It must agree to comply with the law and all rules of the Commission and, to the extent of its authority, to compel compliance by its members. Dominion over members is assured since exchange rules must provide means for disciplining members whose conduct is inconsistent with fair and equitable principles. Wilful violation of the Act or rules is deemed conduct warranting discipline.

Exchange rules and amendments to rules are subject to Commission approval before adoption. Sometimes the Commission recommends changes or new rules. Considerable importance attaches to such suggestions because, if an exchange fails to adopt a rule deemed to be in the public interest, the Commission may order necessary action. Fur-

thermore, members and officers of exchanges are subject to disciplinary actions by the Commission. This fact has, of course, greatly changed the "private club" character of the exchange that prevailed before its incorporation.

There are some exchange rules that apply only to members performing functions in which opportunities for abuse are particularly inherent. Specialists and odd-lot dealers are among those singled out for special attention. They are required to register with the exchange, and non-registered members are prohibited from performing such services. They are subject to rules that confine their operations within narrow limits, provided the operations are justified for the maintenance of an orderly market.

The Commission has considered abolition of floor trading, but this has not been ordered because high taxes, fewer speculative opportunities, and severe restrictions have caused many of the members voluntarily to cease such trading. Those who continue to do so are limited, both individually and as a group, as to prices at which they may buy and the number of shares that they may acquire. Also, if they buy stock off the floors, they must dispose of it off the floor.

Comparable regulation of the over-the-counter market. As originally expressed in the Securities Exchange Act, the intention of Congress was to regulate the over-the-counter market in such a manner as to provide investors protection comparable to that provided for those who utilized the facilities of a registered national securities exchange. Although the statement of this intention was subsequently dropped by amendment, the Commission has preserved the standard and adheres to it to the extent that it is feasible to do so.

The complex structure of the market, the fact that it deals mostly in unregistered securities, and the lack of publicity about transactions, afford exceptional opportunities for taking advantage of investors, and also complicate the task of regulation and supervision. Nevertheless, regulation of the over-the-counter market was imperative when the stock exchange markets were brought under regulation. Without it, there would be a tendency for business to flow from the regulated to the unregulated market. The regulation of the over-the-counter market has been effected by regulating the conduct of over-the-counter dealers and brokers, as explained at page 277.

Registration of securities. Registration is a device to bring within the area of regulation all corporations whose securities are listed. Unless they make full and correct disclosures concerning their affairs and keep such information current, trading in their securities is forbidden. Securities of the Federal Government, states, and municipalities are exempt from registration.

The process of registration is initiated by filing an application with

the Commission, and a copy with the exchange, containing information substantially similar to that required under the Securities Act of 1933. The data are examined for completeness and clarity by the Commission and, if found deficient, must be corrected. Once effective, registration continues, provided the corporation submits annual and current reports necessary to disclose material changes in its affairs. Control over corporations is strengthened by the fact that the Commission may revoke or suspend registration if the company fails to comply with any provision of the Act or any rule. However, such action must be necessary for the protection of investors.

As originally enacted, the Securities Exchange Act granted authority for registration of securities traded over the counter. Practical difficulties, however, prevented achievement of this desirable end. The Act was subsequently amended to require issuers with $2,000,000 or more aggregate securities of the same class as that for which they file a registration statement under the Securities Act of 1933 to furnish periodic reports. Thus, information is made available in a manner similar to that for listed securities, but the requirement applies only to very, very few of the many issues traded over the counter.

Federal regulation of listed and unlisted securities. The Commission has no power to require listing, nor may it prevent delisting, if the provisions of the Act have been met. In connection with delisting it may, however, examine the reasons stated in the application to delist and determine whether or not investor interest is served by granting the application. In some cases it has required that the question be submitted to a vote of the stockholders. The fact that a security is delisted does not preclude a market for it. Very often such issues find a ready and active over-the-counter interest.

In its original form the Act did not provide for unlisted trading, except for a limited time for securities already so traded. An amendment in 1936 permitted extension of the unlisted privilege under very rigid conditions. The general tenor of the provisions is to require protection for investors equivalent to that given traders in listed issues.

Regulation of credit. Before the enactment of the Securities Exchange Act no satisfactory controls existed over credit for trading or carrying securities, or to restrict its use to financially responsible persons. Many speculators borrowed large sums with which to conduct speculative "in and out" trading, frequently with disastrous results to the speculator and, more important, to his creditor.

The loan device to obtain credit for use in connection with securities speculations is called "margin." This is money, or its equivalent, deposited by a speculator with his broker to cover the difference between the amount the broker will lend against collateral and the market price of the security. Brokers may either repledge the collateral and obtain

funds from their commercial banks or lend their own excess funds. Naturally the lender desires that the speculator invest a reasonable amount of his own funds. What is considered reasonable varies with changes in market prices since a fluctuation, if the speculator is sold out or forced to sell, may wipe out not only his personal investment, but may also involve loss of the borrowed funds. Therefore, if the market fluctuates and the investment by the speculator of his own funds (margin) is relatively small, or, to use "street" parlance, if his original margin is deemed "too thin," the broker calls for additional money. If none is forthcoming, he sells the security. The speculator sustains the losses. Losses in excess of the margin, and which the speculator cannot repay to the broker, must be borne by the latter. Speculation by irresponsible persons may therefore cause insolvency of the broker.

The Securities Exchange Act authorized the Board of Governors of the Federal Reserve System to prescribe rules governing extension of credit secured by security collateral. Regulation T covers credit extended to customers by or through exchange members. Regulation U controls credit by banks to customers for buying or carrying securities. As conditions warrant, the Board may raise or lower margin requirements, or even forbid the use of credit altogether. Administrative responsibility is in the Commission for compliance with the Board's rules and its auditors inspect records of brokers and dealers for violations.

Trading by insiders. Investors as a class do not have access to information such as is available to corporate directors, officers, and large stockholders. Because of their relationship to the company, these "insiders" obtain information either exclusively or at times well in advance of publication. The relationship of insiders to the corporation they serve or are connected with is necessarily fiduciary in character. When, therefore, insiders make use of information for selfish ends they are guilty of a breach of their high trust. By speculating in the companies' securities they take an unfair advantage of the investors who do not have access to the information available to insiders.

Trading by insiders is not prohibited, but conditions are imposed upon them which tend to discourage the activity. Each director, officer, and beneficial holder of more than 10 per cent of any class of registered security is required to file with the Commission an initial report of his holdings. Thereafter he must submit reports for each month in which any change occurs. These are all given wide publicity. Profits realized by insiders from transactions made within a period of six months may be recovered from them by civil action brought by the corporation. If the corporation fails to bring suit or to prosecute such action vigor-

ously, any security holder of the company may then carry on the action on its behalf.

Short selling. A speculator who believes prices generally, or for any given security, to be too high and that a recession will probably occur, may make sales even though he owns no shares. Selling what one does not own is called *short selling*. A short seller must make delivery of certificates to the buyer, but since he has none of his own he must borrow them. The short seller must make good to the lender of stock any dividends declared during the period of the loan. If prices decline as expected by the speculator, he buys the required securities he has already sold in anticipation of the price drop, or, in broker's language, he covers his short position, and delivers the shares to the stock lender. The profit on the transaction is the difference between the short sale price and the covering purchase price, less expenses and taxes.

In an advancing market, the effect of short selling in volume is to retard or moderate the advance; in a falling market, the decline is accelerated. Conversely, covered transactions tend to slow up the decline or reduce its magnitude. Although short selling is considered a legitimate trading operation that often serves a useful economic purpose in stabilizing prices and reducing fluctuations, it can be turned to manipulative uses and cause, or accentuate, unwarranted recessions. Today, restrictive regulations are in effect to permit the justified use of short selling and curtail its undesirable employment. Such sales are permitted only at the last previous sales price of the current market and then only provided the last sales price was higher than the last preceding different price. "Short interests" must file reports, which are carefully scrutinized and investigated if suspect. Insiders are forbidden to sell short at any time.

Options. Another controlled speculative device for effecting share transfers is the option. These are dealt in off the floor of the exchange. A "put" is an option whereby the maker agrees to accept a given number of shares of a stock at an agreed price during the option period, if the holder calls upon him to do so. A "call" is an option which permits the holder to call upon the maker within the option period to deliver upon demand a number of shares of a given stock at an agreed price. An option that permits the speculator to demand delivery of stock at an agreed price or to deliver stock against payment of a different agreed price is called a "spread." The same option, if only one price is specified, is called a "straddle." Such contracts are allowed today only under closely prescribed conditions.

Manipulations and frauds. Any transaction or operation in securities, the purpose of which is to induce others to buy or sell a security, or which is used to create the appearance of market activity or to

establish artificial and fictitious prices, is a manipulation. The kinds of manipulations are limited only by the ingenuity of the manipulators. For this reason price movements and the volume of trading are constantly scrutinized. Any unusual fluctuation or sudden extraordinary change in volume is investigated by the Commission. This is only done if the probable causes for the movements cannot be ascertained by study of the known factors influencing transactions in the security affected. The confidential investigation is called a "flying quiz." If legitimate reasons are discovered for the changes or movements, the investigation is ended, but if manipulative influences are uncovered they are immediately suppressed.[2]

The problem of coping with the myriad forms of frauds and unlawful conduct requires great flexibility in the enforcement agency's procedures and powers. Therefore, the Commission has the power to define, prohibit, and provide means for detection of such acts. All fraudulent and improper practices were unlawful even before any Federal legislation. However, the common law doctrine was inadequate, and state statutes, while broader, were still too limited. The Commission, by rules and interpretations, has logically extended the old doctrines to include all manipulations and frauds. It even goes further and includes some activities not actually fraudulent, but on the borderline. Frauds have been reduced to a remarkable extent in number and frequency because of the Commission's alert investigations and prompt invocation of administrative and criminal sanctions. Moreover, the law permits any victim of fraud to rescind a fraudulent transaction and to recover damages.

Some forms of prohibited or controlled manipulation. The following are recognized forms of manipulation that are prohibited or controlled by the Act:

Short sale. A favorite manipulative device before regulation made it ineffective was the short sale. Speculators, individually or in "pools," by selling short in great volume could depress prices and induce others to join in the selling. A "bear raid" of this kind continued until profitable opportunities to cover at handsome profits brought it to an end.

Rigging. Not all manipulations are designed to depress prices. A price which is manipulated so that it bears no relationship to the price which would have been established in a free competitive market is called a "rigged" price. "Rigging" is forbidden, although "pegging,"

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[2] In 1958 the SEC enjoined Louis Wolfson, the Florida financier, from making "misleading and fraudulent" statements about his trading activities in General Motors Corp. stock. A newspaper report quoted Wolfson as saying that he was "about one-fourth of the way home" in disposing of his 400,000 shares of General Motors. At the time the statement was allegedly made, Wolfson and his associates had a substantial short position in the stock.

"fixing," and "stabilizing" are permitted under certain conditions. A "pegged" or "fixed" price is one that is held stationary or within narrow limits. A "stabilized" price is a supported price.

"Wash sales" and "matched orders." When brokers establish fictitious prices or create the appearance of activity in an issue by executing fictitious sales, the transactions are called "wash sales." When speculators give one broker an order to sell and another an order to buy for the same purpose, the transaction is called "matching orders." Both are forbidden by the Act.

Dissemination of misleading information. Sometimes manipulators employ tipsters to recommend transactions in the manipulated issues, or they spread rumors and false information. Such antisocial conduct is severely punished if discovered.

Regulation of over-the-counter dealers and brokers. The problem of regulating the conduct of thousands of independent over-the-counter dealers and brokers with no organizational unity presented major difficulties. The market had developed over a period of many years and had operated mostly according to unwritten rules without any effective means for competitors to discipline those among them who departed from generally accepted fair and equitable principles of trade. It was not until 1934 that the industry, in accordance with the National Recovery Act, incorporated its rules of fair practice into a written code to which securities dealers subscribed and promised to conform. When this Act was declared unconstitutional in 1935, representatives of the over-the-counter market discussed with the Commission the possibilities of creating a dealer organization for self-policing. The result was joint sponsorship of a proposal before Congress which was enacted into law as an amendment to the Securities Exchange Act, known as the Maloney Act. This amendment permits registration with the Commission of national securities associations that undertake to establish and enforce high ethical standards of conduct among their members.

The National Association of Securities Dealers, Inc. The National Association of Securities Dealers, Inc., organized in 1939 as a nonprofit corporation, is the only association formed and registered to date under the Securities Exchange Act. It concerns itself with preparation of rules of conduct for the guidance of its members, and for violations of which they can be punished. It investigates complaints and provides means for settlement of misunderstandings and disputes. It supervises such matters as genuineness of bids and offers, reliability of advertising and quotations, and adherence to fair prices and commissions. It also acts as spokesman to government for its members as a group. Membership entitles dealers to do business with one another on preferential terms not granted to non-members. The organization

passes upon the qualifications of applicants for membership, subject to appeal to the Commission by dealers who are denied admission. When the Commission believes it to be in the public interest, it may, in spite of denial by the association, order the approval of an application.

Partners, officers, salesmen, and other employees of member firms occupying positions that bring them into contact with the public are registered with the association as "registered representatives." Such persons are required to agree to be bound by the charter of incorporation, by-laws, rules, decisions, directions, and sanctions of the organization. Through this association the Commission acquires a measure of control in some ways comparable to that accomplished by registration of stock exchanges and use of the device of allied memberships.

Control over high-pressure sales techniques. One of the purposes of control over salesmen is to prevent the use of high-pressure sales techniques. Sales so made are usually induced by express or implied misrepresentations and failure to disclose material facts. The deception or omission may relate to prices, conditions of the market, or any one or more of many facts considered by an investor when effecting a transaction. Aggressive selling that involves the use of unfair tactics is a breach of the fiduciary relationship which exists between dealers and their customers. Such selling is unlawful under the full disclosure clauses of the Securities Exchange Act.

Inspection of dealer and broker activities. Violations of the Securities Exchange Act are not easily detected by means of market surveillance techniques in the over-the-counter market. Therefore the Commission exercises its "visitorial powers" to check upon the activities of brokers and dealers. Accountants of the regional offices make frequent inspections to determine whether any improper or fraudulent practices are in use. When minor infractions are discovered, they are called to the attention of the firm for correction. Those acts that fall short of good business practices, even though not fraudulent, are also treated in this way. The more serious infractions of rules or the basic law are dealt with much more firmly and usually involve application of a sanction.

Sanctions. Both the exchanges and the dealers' association have the authority to impose administrative sanctions upon their members in relation to the gravity of the offenses committed. These include expulsion, suspension, fine, and censure. The Commission has even greater powers. It may withdraw or revoke a registration, procure restraining orders and injunctions to prevent violations or arrest them in process, suspend or expel members of either the exchange or the association, and issue warnings and reprimands. It may also invoke

criminal sanctions by referring willful violations to the Department of Justice. Matters of interest to state securities commissions and to other Federal agencies are referred to them for action. The goal of the Commission is to secure the greatest possible effective regulation with the least amount of interference and enforcement proceedings.

Self-regulation of securities markets. Before its reorganization, the New York Stock Exchange had all of the characteristics of a private club, and as such was distinctly limited in the manner and extent of self-regulation. Many of the practices that have since been banned or confined to narrow limits were not regarded by the majority of investors or exchange members as conduct within the scope of regulation. Since the provision for tighter controls and closer supervision, the exchange has undertaken a greater measure of self-regulation and self-disciplining than ever before. The considerable freedom the Commission gives the exchange in this respect indicates that the exchange is not shirking its duties.

As previously mentioned, before the creation of the National Association of Securities Dealers, Inc., the over-the-counter market lacked the organizational means and the power to regulate and to discipline. Today it has, and successfully uses, both the authority and the means. It operates according to its own rules, makes complaints and investigations on its own initiative, holds hearings, and imposes punitive sanctions when necessary.

The Commission has followed the policy of permitting both the exchange and the association the greatest possible measure of self-control. Adherence to workable fair and equitable principles of trade is more than a matter of laws and regulations. Without the sincere cooperation of the industry as a whole, legislation would be relatively ineffective.

Broker-dealer segregation. The Act prohibits a member of a registered exchange who is both dealer and broker from effecting the following transactions: (1) transactions in which he extends or arranges for credit for a customer on a security which is part of a new issue in the distribution of which he participated as member of a selling syndicate or group within 30 days prior to the transaction; (2) transactions with a customer, without written disclosure to the customer, at or before completion of the transaction, whether he is acting as dealer for his own account, as a broker for the customer, or as broker for some other person. In the case of persons other than members of registered exchanges, the two restrictions apply only where the mails, the channels of interstate commerce, or a facility of a registered exchange is used in the transaction.

The problem of segregating broker and dealer functions is a serious one, as will be clear from the following explanation. A broker always

acts in a fiduciary capacity for his customer. He is an agent with all the obligations which that status implies. He is not entitled to "profits," but to the regularly established commission for his work. A dealer, on the other hand, acts as a principal in the transaction and the investor is the other principal. The dealer gets no commission, but makes a profit by determining the price at which he buys from or sells to his customers. When the functions of dealer and broker are combined in one person or organization, the possibility of conflict of interest between broker and investor may arise and be resolved to the detriment of the investor. Thus, when one person acts in the capacity of broker in some trades on behalf of a customer, and then deals with the same customer as principal in other trades, it is obvious that occasionally it will be more advantageous for him to act in one capacity than in another. He may choose to act in the capacity that gives him the greatest financial benefit. Many broker-dealers follow the practice of sending notices to customers that they are acting as broker for such customer in all transactions unless otherwise notified.

Conclusion. Since the enactment of the Securities Exchange Act and related legislation, the markets have served issuers and investors with distinction. Elimination of abuses has made them safer and better institutions serving the public interest and responsive to the demands made upon them. Of course, there is not complete or universal satisfaction with the manner in which they function, but by and large, the changes which have taken place have been beneficial.

Research Questions

1. List five corporations whose securities are listed on the New York Stock Exchange and at least one other exchange.
2. List five stocks traded over-the-counter. Are these large or small corporations?

Problems

1. In the following cases would it be preferable to list the security on the New York Stock Exchange or to restrict trade to over-the-counter houses? Give your reason in each case.
   (a) *X* Corporation has 10,000,000 shares outstanding. Earnings per share average $6. The product is well known. At present no stockholder owns more than 3 per cent of the stock.
   (b) *Y* Corporation has been in business for 75 years. Three stockholders own most of the stock but will offer 51 per cent of their 2,000,000 share holdings to the public within a few weeks. Earnings per share are high, but the percentage of return on invested capital is low because of excessive cash held.
2. The *A* Corporation manufactures radios but not television. It is listed on the American Stock Exchange. In the last four months 1,000 shares have

been traded. Earnings are fair and the financial condition of the company is sound. What action would you recommend?

3. The *MP* Corporation is listed on the New York Stock Exchange. It is in sound condition, earnings are good, and prospects for the future fair. The corporation has not filed a financial statement with either the stock exchange or the SEC, taking the position that the stockholders do not complain because they don't receive financial reports. What will happen?

CHAPTER 15

Working Capital

Terminology. The term *working capital* is one of the most misunderstood terms in financial and accounting terminology. This lack of understanding, or perhaps we should say lack of uniformity in the application of the term, is probably intensified by the fact that the term does not appear in the account form of balance sheet (see page 71). Some authorities apply the term to total current capital assets and use the term *net current assets* to designate the excess of current assets over current liabilities that are to be paid within the operating circle. Others take the view that working capital is another name for net current assets and represents the excess of current assets over current liabilities. There is basis for both contentions, but in this discussion the meaning of working capital will be restricted to the excess of current assets over current liabilities. Since the total of one group of items is always designated as *current assets* and the total of another group as *current liabilities,* it seems entirely logical to give a name to the difference between the amounts. It must be remembered that working capital constitutes a part of current assets (Current Assets = Current Liabilities + Working Capital) and the capital invested in them; any comprehensive discussion of working capital embraces current assets and current capital.

Relation of current capital to fixed capital. All business capital is divided into two classes: fixed and current.

Capital invested in current assets is *current capital.* Current assets are assets that in the course of business will be realized or converted within the operating cycle, generally one year, without undergoing diminution in value and without disrupting the organization. Assets usually accepted as current are cash, accounts receivable, and inventories. In the tobacco industry, for example, where the inventory generally takes more than one year to sell, inventory is still considered a

current asset. Hence the term *operating cycle,* or *accounting cycle,* rather than *one year* in the general definition. Readily marketable securities also constitute a current asset when they are held as a temporary investment of cash.

Capital invested in fixed assets and other noncurrent assets is *fixed capital.* The fixed assets are assets of a permanent nature that the business does not intend to dispose of, or that could not be disposed of without interfering with the operation of the business. These assets usually include land, buildings, machinery, equipment, and furniture and fixtures.

Other noncurrent assets include items in which capital is tied up for long periods of time but that are not necessary to the operation of a business. Such assets cannot be considered as current because they will not be converted into funds within the operating cycle. They cannot be considered as fixed because they are assets that the business can dispose of without interfering with its operation. They include long-term receivables, funds for specific purposes, advances to subsidiaries, and prepaid items. Prepaid items, such as taxes, rent, fire insurance premiums, commissions, stationery, and supplies, are expenses of a business that are paid in advance of the time in which they are to be charged off as expense. Accountants frequently classify them as current assets, but for purposes of working capital they are considered noncurrent. Only assets that generate funds can be considered current for working capital purposes.

Current capital must be in proper proportion to fixed capital so that the business may operate smoothly. The approximate proportion must be maintained whether the business is operating at a profit or at a loss. The failure to provide adequate current capital at the inception of a business can and frequently does result in early financial failure. Capital requirements for plants, equipment, and the like are obvious and can be estimated with accuracy. But the promoters all too frequently underestimate current capital requirements; the need is not apparent until the business begins to operate. A serious imbalance might then develop between the productive capacity of the fixed capital and the amount of current capital available to the business.

The proper proportion of current capital to fixed capital varies with the type of business. For example, transportation companies and public utilities require a relatively small amount of current capital because their operating requirements are minor compared to their investment in equipment. On the other hand, retailers and loan companies require a high percentage of current capital to fixed capital. Within each industry there is a proportion of current assets to fixed assets, which cannot be disturbed without impairment to the maximum financial efficiency of the business.

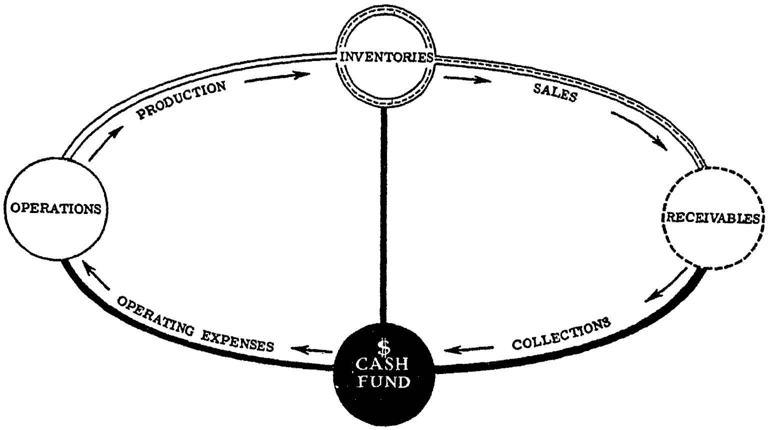
Concept of circulating capital. A term frequently applied in the past to current assets is *circulating capital*. Although the term is not in general usage now, it is an apt expression and draws attention to the circular flow of current capital. The diagram on page 285 illustrates the circulation of current capital.

We may start with cash: Part of it is used to obtain goods that are worked on to produce the product to be sold; part of the cash goes as wages, salaries, and the like, into the operations that produce the product to be sold. The result of sales ordinarily is receivables, that is accounts, notes, and bills receivable; these, when collected, are turned into cash, part of which may be distributed to the owners as profits, and part of which—usually the greater part—will start around the circuit again. If at any time something goes wrong with this circulation of current funds, or if the business grows or temporarily increases, more current funds may have to be injected into the circulation to keep the business in a sound and liquid current position. An extra amount of funds may be needed at the beginning to get the business started; after the circulation *is* started and the parts of the business are properly adjusted, the circulation may be kept up with a smaller amount of current funds in the system.

Relation of credit to current capital. What is *credit?* It is the power to obtain present control of goods or services on the promise to pay for them in the future. The existence of that power in any business depends on (1) the ability of the managers to run their business profitably—including in the term "ability" both physical capacity and mental acumen; (2) the moral character of the managers, sometimes spoken of as their willingness to redeem their promise by payment; (3) the assets of the business itself, especially the current assets. In the diagram on page 285 this power, called credit, may take the place of the cash indicated as being used to purchase the inventories. To be sure, the use of credit for this purpose will create a current liability that later will have to be "met" with cash; but the cash needed when the current liability matures may then be available through the conversion of the inventories into receivables and the collection of these receivables. If, when credit is used, everything moves smoothly, a relatively small amount of cash may be sufficient to keep up the circulation of the current assets. But let something impair the circulation —slow sales or slow collections, for example—and the business is in difficulty; when the current liabilities mature, cash will have to be obtained from some place outside the business. We thus get a graphic presentation of the reason for the old-fashioned rule that current assets should equal twice the current liabilities.[1]

[1] See page 294.

The reader should turn to the more elaborate diagram facing page 287 and study it with the aid of the explanation there given.



Simple Chart Showing Main Paths of Circulating Capital. Solid line, cash; double line, services; dotted line, credit sales; triple line, goods.

Relation of working capital to current assets and current liabilities. The Statement of Financial Position shown on page 286 illustrates our concept of working capital. Although all of the current capital circulates, as described in the preceding paragraphs, part of it is offset by current obligations. For all practical purposes, a portion of the current capital is, in effect, earmarked to meet current obligations. It is the difference between this portion and the total current capital that is available to meet not only the minimum needs of a business during the dullest seasons, but also irregular and unusual needs resulting from seasonal demands, business fluctuations, wide price movements, and emergencies. To continue with the metaphor of the circulatory system, this excess of current capital over current liabilities represents the heart of the business; and if it becomes weak, the business cannot long survive. In other words, when working capital is insufficient to meet the requirements of the business, the business cannot prosper. When the current liabilities exceed current assets, there is a *working capital deficit;* if the deficit continues over a period of time, new funds from permanent sources will have to be brought into the business, or it will fail.

Classification of working capital. The amount of funds needed for operating requirements normally varies from time to time in every business. However, a business always needs a certain amount of assets in the form of working capital if it is to carry out its functions. This permanent need and the variable requirements are the basis for a con-

Comparative Statement of Financial Position for Two Consecutive Years

	July 31, 19.. (Latest year)	July 31, 19.. (Prior year)
CURRENT ASSETS·		
Cash	$ 2,920,213	$ 5,189,186
Governmental securities, at cost (approximately market)		4,171,312
Accounts receivable, less allowance for doubtful accounts	21,422,542	18,635,045
Inventories, at the lower of cost or market	18,999,071	16,371,322
Total Current Assets	43,341,826	44,366,865
CURRENT LIABILITIES:		
Notes payable	2,470,000	
Accounts payable	3,650,803	2,609,843
Accrued expenses:		
Taxes	1,117,845	998,771
Salaries, wages, commissions, etc.	3,028,091	1,993,676
Unredeemed merchandise coupons	926,000	811,000
Provision for United States and Canadian taxes on income	3,687,500	5,270,796
Total Current Liabilities	14,880,239	11,684,086
WORKING CAPITAL:		
Investments in unconsolidated subsidiaries, at cost or less	3,497,887	1,537,137
Investments in other affiliates at cost	1,564,916	684,000
Property, plant and equipment at cost, less accumulated depreciation and amortization	17,510,018	14,825,312
Deferred expense and other assets	1,877,720	1,684,061
	52,912,128	51,413,289
Less, long-term notes payable	9,530,000	10,000,000
STOCKHOLDERS' EQUITY:	$43,382,128	$41,413,289
Represented by:		
Preferred cumulative stock	$ 7,181,300	$ 7,181,300
Common stock, authorized 2,000,000 shares of $1 par value each; issued and outstanding 1,535,074 shares	1,535,074	1,535,074
Capital surplus	5,753,770	5,753,770
Earnings retained in the business	28,911,984	26,943,145
	$43,382,128	$41,413,289

Begin the study of this diagram with the cash fund. Follow the main circumference. Running to the left is cash used to pay employees, whose services applied to the inventories, at the top, produce the goods, which are sold and turned into receivables at right, which when collected come back as cash. Taxes have a first claim on the property and income of the business and are therefore indicated in the form of a fund which may be gradually filled up during the year and then emptied on the tax days. Just below the operating expenses is the asset, deferred charges (insurance, stationery, and other items); this represents expenses that were paid for in advance and that will not be used during the current year In the future, certain operations will draw from this asset rather than from cash.

The next line to follow is cash going off to pay for professional and published services, such as lawyers' and accountants' fees, dues in trade organizations, magazines, tax services, sales services, and the like. These are obtained in the first instance, it will be noticed, through the medium of credit, which credit is returned to the company when the debt thus created is "met" by cash These services are shown as promoting production, in fact, they promote sales and collections as well, but these avenues of promotion have been omitted for the sake of simplicity. In the same way, cash is shown, reading from left to right as the lines emerge from the cash fund, paying for merchandise, defraying sales expenses, redeeming credit given to advertising mediums, meeting the credit obligations arising out of the issue of bonds (note the sinking fund where cash may be accumulated in the form of securities, and so forth), and paying the collection expenses.

In the very center is the vertical line indicating cash for administrative overhead and repairs, and carrying the profits into the surplus, part of which is to be turned out as cash dividends The funds that go into sales and advertising promote the sale of inventories and their conversion into receivables. It will be seen that the credit department promotes the conversion of receivables into cash by its collection methods and that it prevents stagnation by cutting out sales to customers of doubtful credit standing Just below receivables will be found cash discounts granted to customers; these tend to accelerate the conversion of receivables into cash

The success of the business depends largely on how rapidly the circulating capital is kept moving. For some reason—rapid increase in sales drawing off inventories, insufficient sales stagnating inventories, failure of debtors, or rapid increase in operating or administrative costs—cash may be drawn out more quickly than it is replenished through conversion of receivables In such an event, more cash must be injected into the circulating system If the business has expanded, perhaps a permanent increase should be furnished through the sale of additional stock or bonds to potential investors —this operation is shown below and to the right. (Or the increase may be furnished through the sale of unnecessary fixed assets, an operation not shown on this chart)

But temporary relief only may be needed In such an event, the concern may convert its marketable securities into cash (at right) or borrow from friends and employees (left) Or it may take from its customers notes (the dotted line running out of receivables) or accepted drafts, and discount them at its own bank or through a finance company; or it may sell or assign its accounts receivable as security for a loan. The bank may rediscount the accepted draft (trade acceptance) at its Federal Reserve Bank. Customers may draw on their own banks and these bank acceptances may be sold to a discount house, which may sell directly to a Federal Reserve Bank. Again, the company may take its own note to its own bank or may take a series of notes to a note broker who will sell them to outside banks. Moreover, under certain conditions the company may draw on its own bank, the latter may accept the draft, and in that form, as a banker's acceptance, the draft may be sold to other banks. These bankers' acceptances, under certain limitations, may be rediscounted with the Federal Reserve Bank, or the Federal Reserve Bank may buy the acceptances in the "open market" from the commercial paper houses The operations of the various credit institutions and banks are fully described in the next chapter.

venient classification of working capital either as *regular,* or *permanent,* or as *variable.* Variable working capital may be further classified as either *seasonal* or *special.*

Regular working capital. Every company needs such an excess of current assets over current liabilities as is necessary to keep up the circulation of the capital from cash to inventories to receivables and back into cash. No business can afford to run the innumerable risks of enterprise without some current capital over immediate needs. Some of the current capital must be regarded as requiring a permanent investment of funds. The amount of the investment that it is deemed expedient to carry in this form from month to month and year to year is regarded as the *regular* or *permanent working capital* of the business. A retail store is a good example of the importance of regular working capital. Each item of the inventory in a store is for sale; yet there must be an inventory of goods on hand at all times. Thus, although the physical inventory is truly "circulating capital," there must always be an *investment* in goods on hand.

It is apparent, therefore, that this regular working capital should be raised as fixed capital is raised, through a permanent investment of the owners or through long-term borrowing. As business expands, this regular working capital will necessarily expand. If the cash returning from sales includes a large enough profit to take care of expanding operations and growing inventories, the necessary additional working capital may be provided by the earned surplus of the business. But whether the earned surplus, more properly called *retained earnings,* should be used for this purpose is a question of dividend policy that we shall discuss later.[2] Here, however, we must warn against the assumption that no part of the working capital is permanent, and that, therefore, all the circulating capital can be provided through short-term borrowing.

Seasonal working capital. Beyond initial and regular working capital, most businesses will require at stated intervals a larger amount of current assets to fill the demands of the seasonal busy periods. Thus, in the wholesale fur business extra funds will be necessary in the summer; in the dry goods business extra funds will be necessary to initiate the purchasing of goods for the four seasons of the year.

A company is ordinarily in its most liquid position when it is at the bottom of the slow season. It then has some materials and supplies on hand; its accounts receivable are low because collections have been made on outstanding accounts and with slow sales little has been added to the outstanding accounts; and it has more cash on hand than it needs at the moment. As the busy season approaches, it must buy

[2] See Chapter 20.

more materials, hire more help to convert the new purchases into goods in process and then into finished stock. As the stock of finished goods increases, cash declines, and it may become necessary to borrow funds to carry the company along with its production program. As the company approaches the selling period, its stocks of finished goods reflect its readiness to meet the demands. With the increase in sales, inventories decline, receivables keep increasing, and in time the cash will be built up by collection of outstanding accounts, and any loans made will be paid off. The cycle of funds will end when the company is again at the bottom of the slow season.

The illustration below presents a series of statements of current assets and current liabilities taken from a company's records of a typical year at significant dates.[8] The company has only a single selling season.

	December 31	March 31	May 31	September 30
Current Assets				
Cash	$19,488	$ 1,877	$ 904	$ 8,266
Accounts receivable	8,388	8,189	10,017	62,968
Inventories				
Raw material, supplies	20,118	6,863	783	619
In process	—	6,211	4,233	—
Finished goods	3,451	29,456	50,931	5,520
Total	$51,445	$52,596	$66,868	$77,373
Current Liabilities				
Accounts payable	$ 173	$ 472	$ 740	$ 295
Notes payable	—	—	11,250	6,800
Total	$ 173	$ 472	$11,990	$ 7,095
Working Capital	$51,272	$52,124	$54,878	$70,278

Selected Statements of Current Position of the Fourth of July Company, Illustrating the Financial Cycle of Current Operations.

The affairs of the Fourth of July Company are shown at their seasonal low in the December 31 figures. An accumulation of materials and supplies (powder, fusing, wrapping, etc.) is on hand; the accounts receivable have been worked down to a group of difficult collection problems, and the cash fund is ample. It may even seem excessive. December, then, sees the Fourth of July Company in relatively liquid condition, with a good stock of raw materials on hand.

[8] The example and discussion of the Fourth of July Company is from the chapter "Financing Needs for Current Operations," by Pearson Hunt and James T. S. Porterfield, in *Corporate Treasurer's and Controller's Encyclopedia*, ed. Lillian Doris (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1958).

By March 31, the production season is well under way. More raw materials have been purchased, yet the flow of production has converted the new purchases and much of the December stock into goods in process, and then into finished goods. Little progress has been made with the slow receivables. Cash has fallen greatly, due to the increased investment in inventory, especially the finished goods. But so far the company has not exceeded its capacity to supply its own current capital. Accounts payable have grown, but the dollar amount of growth is small.

By the end of May, the production program is substantially completed. More funds have been invested in labor and materials, and most of the goods are finished and ready for sale. Some goods have already moved into customers' hands, as the growth in receivables shows. The cash account is at the lowest figure of the year. Furthermore, the large investment in finished goods has more than exhausted the company's own cash fund, so $11,250 has been added to the circulating capital by borrowing. June is to be the big month of sales, and the May 31 statement reflects the company's readiness to meet the demand.

At the end of September, the plant has been shut down. There is a small stock of unsold goods, and the raw material inventory is as low as it can get. Receivables, on the other hand, are very high. They reflect the transfer of the funds invested in inventory *with the addition of profit* into the obligations of customers. Cash has been built up from collections already made, and the loan has been paid off in part.

The cycle of funds for the Fourth of July Company will end in the ensuing December, with a condition similar to that at the end of the preceding year end. It will be observed that some of the high earnings that are shown by the growth of working capital to September 30 will have been eaten away by salaries and other expenses before the next season begins.

The case of the Fourth of July Company is, of course, extreme, but it shows the shifts in the nature of the current assets on hand during the cyclical period. As these changes take place, there is a change in the risk that a lender takes in making funds available to the borrower, and hence in the availability of credit. A corporation ordinarily finds it easier to borrow after the seasonal sales have been made, that is, to finance receivables, than to finance purchases of material that must be processed before sale.

Although some businesses will always have the problem of financing seasonal operations, the tendency has been toward smoothing out seasonal fluctuations by product diversification. A company that does not have a seasonal circulating capital problem has these advantages over the seasonal business: goods can be bought as they are needed instead of three or four months in advance, avoiding a tie-up of capital for long periods; price changes in goods purchased can be more quickly reflected in selling prices if goods are bought to meet the needs of only a short period.

Special working capital. Most businesses need cash funds not only to get the business of buying and selling started, to keep good the

credit for ordinary dealing, and to meet seasonal demands, but they also need at unstated periods extra funds to meet contingencies, such as the following:

1. Rising prices may affect the amount of current funds. When prices of commodities rise, it becomes profitable to increase inventories, since the resale price may include appreciation in value during the period in which the materials are being held for manufacture and sale.

2. Business recessions, too, may raise the amount of cash required. Though some businesses feel the halting hand of general recession more than others, all businesses require plenty of cash to ride out unusually stagnant periods.

3. Contingencies, such as strikes, fires, and unexpectedly severe competition, may use up extra supplies of cash.

4. Special operations, such as the inauguration of extensive marketing campaigns, experiments with products or with methods of distribution, carrying out of special jobs, such as war contracts, contracts to supply new businesses, and similar operations that are outside the usual business of buying, fabricating, and selling, may require additional funds.

Advantages of ample working capital. Adequate working capital is essential, for without it trouble is inevitable. Although current liabilities are paid from funds generated by current assets, the working capital should be sufficient in relation to current liabilities to afford a margin of safety. From whatever source the demand for current funds arises, the business that has ample funds to meet all needs may count itself fortunate.

The specific reasons why ample working capital is essential are discussed below. Most of these reasons indicate a need for cash, which will be forthcoming if a strong working capital position is maintained.

1. The most important reason for having working capital is to avoid technical insolvency. To maintain the solvency of a business and continue production, it is necessary that adequate funds be available to pay for material, direct labor, selling and administrative expenses, and other costs of doing business.

2. Credit is maintained. Prompt payment to suppliers of materials will not only insure a continued supply of raw material but will establish credit for the future or for seasonal operations. From a very practical standpoint, the credit rating of a business is based on its capacity to pay and on the promptness with which payments are actually made.[4]

3. Cash discounts may usually be taken, thus increasing the earn-

[4] Dun & Bradstreet, Inc., the principal commercial agency, gives a double rating, one for estimated financial strength, and one for general credit. Thus, AA-A1 means that the financial strength is $1,000,000 or over (AA), and the general credit is the best (A1).

ings of the business. Perhaps the usual terms on which goods are bought in business are what the credit man calls "2/10, net 30." These words mean that if goods purchased are paid for in cash within ten days from the date of delivery, the purchaser may subtract 2 per cent from the amount of the invoice; this deduction is called the *cash discount*. The goods are supposed to be paid for at any rate within thirty days after delivery. Thus a purchaser gets 2 per cent discount for paying twenty days earlier than the date on which the obligation matures. The discount, therefore, is practically at the rate of 2 per cent for twenty days, or 36 per cent per year.[5]

4. Banks are more willing to grant seasonal loans if the business is adequately financed in the first place and has a good credit standing and trade reputation. In order to borrow from banks, a business must keep itself in fairly liquid condition.

5. In the lifetime of most businesses there comes a time of emergency when additional funds are needed. These funds will be available because security in the form of adequate working capital will warrant an extension of credit or the granting of a loan.[6]

6. Every stockholder expects to receive, in the form of dividends, a return on the money he has invested in a business. When working capital is not adequate, the profits have to be kept in the business. This

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[5] Cost of credit for other terms of sale is indicated in the following table:
One-half per cent in ten days—net 30 days—equals 9 per cent a year.
One per cent in ten days—net 30 days—equals 18 per cent a year.
One and one-half per cent in ten days—net 30 days—equals 27 per cent a year.
Two per cent in thirty days—net 4 months—equals 8 per cent a year.
Two per cent in ten days—net 60 days—equals 14 per cent a year.
Two per cent in thirty days—net 60 days—equals 24 per cent a year.
Two per cent in ten days—net 30 days—equals 36 per cent a year.
Three per cent in ten days—net 4 months—equals 10 per cent a year.
Three per cent in thirty days—net 60 days—equals 36 per cent a year.
Three per cent in ten days—net 30 days—equals 54 per cent a year.

[6] During the period of prosperity that lasted from 1925 to 1929, many large corporations took advantage of the strong market for investment securities and raised working capital by the sale of common stock. With part of the proceeds they paid off a portion of their floating debt, thus improving their current positions. As a result of this financing, when the depression of 1929 arrived they were in a position to cope with the tightened credit conditions and were not entirely dependent upon commercial banks to aid them through difficulties. See, however, an article by Badger and Behrens, "Financing by Stock Rights," in *Investment Banking,* April, 1931, page 37, in which, from a study of the financial statements of twenty-four large industrial corporations, the conclusion is reached that except for a few isolated cases there is no evidence that corporations entered either the year 1929 or 1930 with more than a normal amount of working capital. A later study by Arthur H. Winakor, entitled *Maintenance of Working Capital of Industrial Corporations by Conversion of Fixed Assets,* Bulletin No. 49 (1934), University of Illinois, based upon financial statements of 182 companies operating in 16 different industries from 1927 to 1932, inclusive, indicates that at the beginning of the depression most corporations were well endowed with working capital and special reserve funds of marketable securities. Since the depression, working capital policies have tended to be distinctly conservative in well-financed companies.

makes it very difficult to raise money for future operations. People are unwilling to invest their money in ventures that do not return a yearly dividend.

7. Efficiency is maintained. Ample working capital prevents the decline in efficiency that sets in when operations are impeded by lack of material and by delays in obtaining necessary supplies. Steady production means steady work for employees, which raises their morale, increases their efficiency, lowers costs, and creates goodwill in the community.

Disadvantages of redundant working capital. When a balance sheet shows an amount of working capital coniderably in excess of the requirements of the business, usually the condition has been deliberately created because management wants to be on the safe side. Sometimes it reflects a temporary postponement of the use of funds that have been budgeted for capital expenditures. Although cases are rare in which companies have redundant working capital, conditions sometimes arise in which a business finds itself, for a period, with much larger supplies of cash on hand than are needed. Such a condition contains the following elements of danger:

1. The business cannot earn a proper rate of return on its investment because capital has been supplied that is not being used in the normal course of operations. This excess might better be taken out and returned to the stockholders to be employed in a more profitable manner.

2. Large working capital is the converse of low current debt. Since a concern might do more business if it had larger current debt, a plethora of working capital may be taken as an indication that the managers are not expanding their business.

3. Waste may be encouraged, especially through the purchase of excessive inventories and fixed assets. It is difficult to control unnecessary purchases or to change management policy when there is ample money to pay the bills.

4. The corporation is likely to lose sight of maintaining relations with its banks that will assure credit when the need for it arises.

5. Section 531 of the Internal Revenue Code imposes a penalty tax for improperly accumulating surplus. The test in almost every case is whether or not the surplus is beyond the reasonable needs of the business. The penalty provision makes it advisable to pay out a portion of earnings to stockholders of a corporation. Excessive working capital due to retained earnings only might be an indication to the taxing authorities that the surplus accumulated by the corporation was beyond the reasonable needs of the business.

6. Closely held companies with large holdings of liquid assets in excess of operating needs usually find that when they consider making

a partial sale of the owners' holdings to the public, for purposes of obtaining funds for estate taxes or to diversify the owners' investments, they run into difficulties. In a typical public sale, the price for the stock is generally determined by the probable earnings and dividends in relation to those of other similarly situated companies. "Generally speaking, relatively little attention is paid to asset values or to the possession of excess working capital when there is no assurance that earnings or dividends will be affected by such holdings. Thus, the market price of the stock of a company with excess working capital ordinarily will sell at only a relatively small premium on account of these holdings." [7]

What is the proper amount of current and working capital? The answer to this question may be given in the words of Lincoln in his famous reply to the inquiry, "How long should a man's leg be?"—"Long enough to reach the ground." In every case the circumstances surrounding the individual company must be taken into consideration.

The old theory was that working capital should equal current liabilities, that is to say, that there should be $2 of current assets for every $1 of current liabilities. This is the familiar "two-to-one" rule. It was based on the belief that an allowance of 100 per cent should be made for shrinkage in circulating capital in the event of a forced liquidation. The ratio has been criticized as a dangerous tool when carelessly used, because it fails to give weight to the variations in liquidity between the component parts of the ratio. The liquid position of the company is better determined by an analysis of the liquidity of each of the items that make up the current ratio. For example, what significance has a high current ratio if much of the inventory is obsolete and unsalable, if the accounts receivable are slow or uncollectible, or if the finished goods are overpriced?

Although the working capital ratio is not a test of the adequacy of working capital, it is an indication of the extent to which current assets may shrink and still be sufficient to take care of current liabilities. The *amount* of working capital is not an adequate measure of sufficiency. Comparison of the working capital positions of two companies demonstrates this fact:

	Company A	*Company B*
Current assets	$10,000	$100,000
Current liabilities	5,000	95,000
Working capital	$ 5,000	$ 5,000

Both companies have the same amount of working capital, but their current positions differ radically. The current assets of Company *A*,

[7] Butters, Lintner, and Cary, *Effects of Taxation—Corporate Mergers*, p. 149. Boston: Division of Research, Graduate School of Business Administration, 1951.

even with a 50 per cent shrinkage, are sufficient to meet the current liabilities, but Company *B* can afford only a 5 per cent shrinkage.

The two-to-one ratio may be found satisfactory in some industries and entirely too low in others; it may be found sufficient at one phase of the business cycle and insufficient at another. Ratios in addition to the current ratio are at present used to determine the current position of the company. They are described subsequently in this chapter.[8]

Although no definite rule can be established for determining working capital requirements, we can arrive at some general principles. Certain influences, some inherent in the nature of the business and others arising out of business management policies, affect each of the items of current capital. In the following paragraphs both of these types of influences on cash, inventory, and accounts receivable are discussed.

Influences on cash working balance. Businesses with regular gross income in the form of cash prepayments for goods or services need relatively small cash working balances. If the bus company with its sign, "Pay as you enter," cannot meet demands for cash, the trouble is not with the working capital, but with the whole business. To the extent that either regularity of income or cash terms are lacking, the supply of cash funds should be increased. Public utilities are the best example of businesses in which the elements of both regularity of income and cash terms are strongly present. A retail store, on the other hand, may do a "cash" business, but its income may be very irregular because of seasonal sales or because it sells a type of product—luxuries, for example—that is quickly influenced by declines in general business activity.

Influences on size of inventory. The following are the principal influences on the size of the inventory:

1. *Time consumed in manufacture.* Obviously, the longer the period of manufacture, the larger the inventory required. However, if the flow of products is quite steady, although the value of goods in process is large, the working capital will not vary much from time to time. A large part of the goods in process, under these circumstances, may be regarded as strictly a fixed asset.

2. *Need to stockpile raw materials.* The necessity for stockpiling increases the amount of funds tied up in inventories. In certain lines of business stockpiling is expedient. For example, where the materials are bulky and best purchasable in large quantities, as in the cement business, stockpiling is usual. Where labor stoppages are frequent,

[8] Various ratios, including current position ratios, are analyzed in Chapter 18, "Analysis of Financial Statements," but some discussion of them here is essential to an understanding of the principles governing working capital requirements.

stockpiling may be advisable. For example, public utilities that must have adequate supplies of coal to assure steady service, stockpile their inventories of coal because of possible coal strikes. Where a business uses seasonally grown raw products, stockpiling may be common practice. For example, food manufacturers stock up on farm-raised products at the end of the growing season.

3. *Need to store finished goods.* Inventories of finished goods are necessarily large in businesses that are compelled to store manufactured goods during the dull seasons. The obvious example is the toy manufacturer who keeps building up finished goods inventory for the Christmas trade.

4. *Time consumed between order and delivery.* An important influence on inventory size is the time involved between order and delivery of the goods. When the time element is uncertain, a larger amount must be invested in raw materials. Efficiency in handling inventories and getting deliveries from railroads and other transport agencies to and from markets makes it possible to carry comparatively low inventories.

The above items are principally influences inherent in the nature of the business. Management policy may also affect the size of the inventory. Thus, a policy of hand-to-mouth buying keeps inventory figures low whereas buying for future needs increases the inventories. Although at one time hand-to-mouth buying was practiced principally in periods of declining prices, today it is practiced by most companies at all times. The basic reason for the change in practice is the speed with which deliveries can now be made.

Inventory turnover. The ratio of annual sales to inventory, or the number of times the inventory turns over, reflects the influences just discussed. The turnover is important because the higher the rate, the higher is the volume of business that can be conducted with a given amount of inventory. Also, the higher the inventory turnover, the lower the risk of loss through price declines and through changes in styles and in demand.

We shall discuss first raw materials inventory turnover and finished goods inventory, and then point out the significance of inventory turnover.

Raw materials inventory turnover. The raw materials turnover is computed by dividing the amount of goods consumed during the period by the average raw material inventory during the period. The purpose of computing the ratio of raw materials inventory to raw materials consumed is to determine whether capital is unnecessarily tied up in raw materials inventory. The following computation illustrates the procedure.

RAW MATERIALS TURNOVERS

Raw materials used	(a)	$250,000
Average raw materials inventory:		
Inventory at beginning of year	(b)	$ 10,000
Inventory at end of year	(c)	11,000
Average inventory (½ of b + c)	(d)	$ 10,500
Turnovers (a ÷ d)	(e)	23.8
Average number of days per turnover (365 ÷ e)		15

The computation may be expressed as a formula:

$$\text{Raw materials turnover} = \frac{\text{Raw materials used during the period}}{\text{Average raw materials inventory during period}}$$

The turnover should compare with the lapse of time between the placing of an order and delivery of the raw material. Thus, in the above example, if the delivery time is two weeks, then the average raw material inventory should be $10,500. Anything over that amount would be excessive unless warranted by economic conditions or special price advantage. Anything under that amount would result in stoppage of production.

Finished goods inventory. The ratio of sales for a given period to inventory represents the number of times the inventory turns over in that period. The turnover is calculated by dividing average inventory into sales at cost. This practice should be followed because merchandise is usually carried on the books at cost. The average inventory is one-half the sum of the merchandise at the beginning and at the end of the year. If monthly inventories are maintained, the average of the monthly inventories should be used.

The following computation is illustrative of the procedure in calculating the turnover.

FINISHED GOODS TURNOVER

Cost of goods sold	(a)	$500,000
Average finished goods inventory:		
Inventory at beginning of year	(b)	$ 35,000
Inventory at end of year	(c)	39,000
Average inventory (½ of b + c)	(d)	37,000
Turnovers (a ÷ d)	(e)	13.5
Average number of days per turnover (365 ÷ e)		27.

The above computation may be stated as a simple formula:

$$\text{Finished goods turnover} = \frac{\text{Cost of goods sold}}{\text{Average finished goods inventory at cost}}$$

The turnover is important because the higher the rate, the higher the volume of business that can be conducted with a given amount of inventory. Also, the higher the finished goods inventory turnover, the less risk there is of loss through price declines and through changes in style and demand.

In manufacturing industries, the turnover should be compared with the period of time consumed in manufacturing to determine whether funds are being tied up unnecessarily in finished goods. Assume that the process of manufacturing takes 12 days. Allowing three days as a possible work stoppage, we see that the finished goods inventory should be equal to fifteen days of production; therefore the ideal finished goods turnover would be twice a month. If the turnover is lower than twice a month, management should investigate to determine whether the inventory includes slow-moving and obsolete items or whether the business is overstocked.

If only the total annual sales and the inventory are known, it is necessary to assume a certain profit on the sales to arrive at the cost of the sales. Thus, if a store has $625,000 of sales and an average inventory of $28,000, we may assume that of the $625,000 about $250,000 is profit, leaving "sales at cost" of $375,000, giving an inventory turnover of 13.4 (13.39 plus, to be exact). Another way to figure the turnover when cost of sales is not known is to assume a certain "markup," that is, the percentage by which a merchant increases the cost of goods to arrive at his selling price. In a retail business the markup is figured as a percentage of the *selling* price. In the foregoing example we assumed a markup of 40 percent (250,000 ÷ 625,000). The inventory at cost figure of $28,000 would be converted to $46,666 ($28,000 ÷ .60, the complement of 40%), which divided into sales (gross, not cost, since we have added the profit to the merchandise and therefore may leave it in the sales) yields the same turnover of 13.4.

All factors affecting the inventory level, such as seasonal merchandise, prompt delivery, and special service to customers, should be considered in studying the ratio of sales to inventory.

Significance of inventory turnover. The significance of inventory turnover lies not in its relation to cash requirements but in its relation to earning power. It is a mistake to assume that a quick turnover reduces *cash* requirements. Assume a hardware store with a turnover of one a year and a grocery store with a turnover of six a year and assume that each has the same average amount of stock on hand, namely, $25,000, and that each sells for cash. The grocery store, having to replenish its stock more frequently, will need more cash than the hardware store. Both stores will at the outset use up a definite amount of cash in stocking up, but thereafter the hardware store will need less cash than the grocery store to keep a full line on hand. To

be sure, if we compare two grocery stores with the same annual sales, and if we assume that one can sell its stock more quickly than the other, the former will have less cash tied up permanently than the latter, because of the more frequent turnover.

The impression should not be left that quick turnover is not distinctly advantageous to a business. The chief advantage is its effect on earning power. If a certain profit is made with the turnover of an item or total product, increase in the turnover should result in an increase in the total profit. Of course, turnover is inherently slower in some businesses than in others, but in the same line an enterprise with a rapid turnover will have a greater earning power than competitors with slower turnover, other factors being equal.

Rapid turnover is also a safeguard against the hazards of obsolescence, damage to stock, and decline in prices and in demand for the product.

It is obvious that the ordinary merchandise turnover is a factor that should be closely watched. The executive should compare his current turnover with those in previous years and with those in similar businesses.[9]

Influences on size of receivables. The following are the principal influences on the size of accounts receivable and other current assets representing amounts due from customers:

1. *Terms of sale.* When cash prepayment or cash is not stipulated, the terms of sale have a decided effect on the size of receivables. If customers are given "easy terms," current capital will tend to pile up in receivables and some form of financing these receivables may be necessary. If trade acceptances and sight drafts are used in selling to customers, this practice will also affect the company's needs for current funds and its method of obtaining them. These methods will be explained in the following chapter when sources of funds for current operations are discussed.

At this point the problem of financing often becomes a problem in sales management. If, for example, goods are sold to be delivered several months later and a customer is then to have thirty days' credit, the selling house may have to pay a commission immediately to its representative who made the sale, though no cash will be derived from the sale for three months. In such a case the customer may be induced to pay some cash in advance—a suitable discount being of-

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[9] Each year, Dun & Bradstreet, Inc. makes available a series of ratios for many lines of manufacturing, wholesale, and retail businesses. Among the ratios is that of net sales to inventory. If a company is in one of the lines of business included in the table of ratios, it can compare its own ratios with those for the line of business as a whole. The company must, of course, figure its ratios by the method used in compiling the table.

fered—and the salesman may be led to make the sale on the cash advance basis by being offered a differential commission, that is, for example, a commission of 18 per cent for a credit sale and a 20 per cent commission if the sale is made on a cash-with-order basis. Moreover, a part of the commission may be "n.c.u.p."—"no commission until paid."

2. *Effectiveness of credit department.* The efficiency of the credit department in extending credit and in making collections influences the size of the receivables. In the first place, the credit department must see that bad accounts do not get into the receivables. The whole subject of checking credits is one for another treatise.[10] The credit department, it should be pointed out, has a problem in balance. If it is too lenient in checking orders, stagnant accounts will result; if it is too drastic, stagnant inventories will result. The proper course is to use due diligence in checking orders promptly, thus aiding sales, and in checking them correctly, thus aiding collections.

The second duty of the credit department is that of collections. Much has been written elsewhere on the subject. Here we need merely say that (1) vigilance should be the motive power, (2) courtesy the lubricant, and (3) decision, when forceful means are needed, the transmission. Thus will receivables, once they are created, be translated with due celerity into cash. The best insurance against stagnant receivables is a proper record and analysis that will enable the management to check the efficiency of the collection department. Several methods of doing this are in practical use, but a discussion of them is not within the scope of this book.[11]

3. *Policy as to sale of receivables.* Sale of accounts receivable is one method of converting receivables into cash quickly. This method of raising funds may be used (1) where the practice is usual in the trade, (2) where accounts receivable constitute a large part of the assets of the business, as in the case of firms selling principally on the installment plan, or (3) where the company's credit is weak and other methods of raising funds for working capital needs are not available to it. The methods by which loans secured by accounts receivable are effected will be discussed in the next chapter. Here it is sufficient to mention that the policy of the firm with regard to accounts receivable financing influences the size of the receivables.

Turnover of accounts receivable. The number of times the receivables turn over during the business year reflects the influences just described. Receivables turnover is found by dividing the annual net sales by the average monthly receivables. Thus, if credit sales for the

[10] See Ettinger and Golieb, *Credits and Collections,* Fourth Edition (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1956).

[11] *Ibid,* Chapters 17 and 18; also see Chapter 21 for a discussion of credit insurance.

year amount to \$1,400,000 and the average monthly receivables is \$130,000, the turnover of receivables is \$1,400,000 divided by \$130,000, or 10.8. When this ratio is divided into 360,[12] the average collection period is found. In the example just given the answer would be 33.3 days; that is, receivables are converted into cash every 33⅓ days.

Note that in the computation the *total* net sales figure is used because the accounts receivable figure also includes a margin for profit.

Significance of accounts receivable turnover. Turnover of a company's receivables is an important factor in determining working capital needs. The turnover is also figured by management to test the efficiency of the credit and collection department.[13] When the average age of the accounts receivable greatly exceeds the normal credit period, the reasons must be sought. The company may have been too liberal in extending credit. Its collection department may have been too lax in following up slow customers. Or collections may have slowed up because of general abnormal business conditions. Management must study the reasons for slow turnover and correct its policies of credit extension and its collection procedures to free cash for other purposes.

In analyzing the ratio of accounts receivable to credit sales, consideration should be given to the discount factor. A simple example will illustrate the importance of the discount terms in relation to the turnover of accounts receivable. If the monthly sales amounted to \$75,000 and the sales terms were net 30 days, the ideal amount of receivables would be \$75,000, or a turnover of once each month. On the other hand, if a discount of 2 per cent were offered for payment in ten days, the ideal amount of accounts receivable outstanding would be \$25,000 (\$75,000 ÷ 10/30). However, the advantage of giving \$18,000 of discounts on annual sales of \$900,000 (\$75,000 × 12) would have to be weighed against the saving of \$50,000 in working capital needs. Offering 2 per cent discount for 20 days' use of customers' money is equivalent to paying 36 per cent on funds (360 days ÷ 20 days × 2 per cent). If normal interest rates for money were 4 per cent, obviously it would be better to eliminate the discount and borrow \$50,000 for current capital or invest that additional amount in the business. However, it may not be possible to eliminate the discount practice if other firms in the trade offer it. The best customers, from a credit point of view, are the ones who take the cash discount, and they are likely to give preference to sellers who continue to offer the discount.

Working capital turnover. The efficiency of money used as working capital may be determined by finding how many times working capital is turned over in a stated period. The turnover is found by

[12] It is customary to use 360 days instead of the accurate 365.

[13] See page 300.

dividing net sales by working capital. Expressed as a formula, the computation is:

$$\frac{\text{Net sales}}{\text{Working capital}} = \text{Turnover of working capital.}$$

An example of working capital turnover may be provided by using the balance sheet on page 71, together with a figure from the Statement of Income of the company whose condition this statement represents. The balance sheet shows working capital of $28,461,587. The Statement of Income shows net sales of $107,658,268. Thus the turnover for the year was 3.78.

Turnover figures for a current period are compared with corresponding figures for previous periods. They are also compared with similar ratios in other concerns in the same line of business.[14] If working capital turnover is comparatively high, that is, if each dollar of working capital produces a large number of dollars of sales, it is usually a reflection of efficiency in management. However, if the turnover is abnormally high in relation to other corresponding periods, or in comparison with other companies in the same line of business, it may prove dangerous, should inventory requirements rise suddenly or should collections fall off unexpectedly. If comparison shows turnover to be abnormally low, it may be a sign that management is lax, that the company could increase its volume of business without requiring additional capital, or that expansion or investment of funds may be desirable.

Management of current capital during prosperity. With business booming, management is inclined to spend money freely. To conserve its current capital it must guard against wasteful expenditures, laxity in employment policies, unwarranted expansion of production facilities, introduction of unnecessary records, and the like. It must guard especially against undue expansion of inventories at the height of the active period.

As activity creeps upward, the credit department must exercise more caution in granting credits and in making collections. To speed up collections no changes are ordinarily required in the established system of watching overdue accounts, if the system is efficient. Usually, a speed-up in the firm's normal collection procedure is all that is necessary.

Management of current capital in a recession. During a period of recession there is usually an acceleration of effort on the part of management to correct the free spending of the prosperity period. Costs are watched more closely and efficiency is improved. Such measures are absolutely essential or the debts that have piled up during the

[14] The Dun & Bradstreet, Inc. tables referred to in note 9 include turnover of net working capital for a large number of lines of business activity.

prosperity period could not be liquidated. The company may change the terms of payment after sales have been made, in order to get customers to anticipate the due date of payment. The practice is not to be commended, however, since it raises the question of violation of "one price" policy and suggests to customers that the house is weak and that better terms may be negotiated than those offered. As sales fall off, to get money, prices may have to be slashed and losses taken. Special sales may help turn inventories into cash. A horizontal cut in prices for all goods may be necessary.

Sometimes heroic means must be used to transform inventories into cash. The story of how Henry Ford raised cash in 1920 is so interesting and illustrative of the problems and possible solutions that most of it is given here, largely from Mr. Ford's own description of what happened.[15]

I. THE PROBLEM—GENERAL BUSINESS CONDITIONS

During World War I, Ford's business, like others, had expanded. After the end of the war he foresaw that stern adjustments would be necessary, especially to close up the holes that had been created in the organization by war-time employment practices. Early in 1920 the first indications of the need for retrenchment were visible in occasional business failures here and there. By June, sales of Ford cars were falling off at a great rate. Yet materialmen demanded higher prices, and labor seemed to give less and less. The cost of manufacturing went soaring.

II. THE PROBLEM—FORD'S FINANCIAL NEEDS

Between January 1 and April 18, 1921, the company had to meet obligations of $58,000,000 at a time when they had only $20,000,000 in cash. Wall Street bankers thought Ford's "back was to the wall." They offered to help him, but Ford was not interested, because he thought he could finance all of his company's needs himself. But he listened to the bankers' emissary. When it became clear that the bankers wanted to have some say as to who would be the next treasurer of the company (the former one had resigned) Ford handed the banker his hat and showed him where the door was.

III. THE SOLUTION—(A) CUT IN PRICE OF CARS AND FORCING REDUCTION OF PRICE OF SUPPLIES

Ford solved his problem in this way. In September, the company cut the price of the cars, although they still had large supplies of stock bought at high prices. The cut brought the price below the cost of manufacture. But that helped sales only temporarily. They soon fell off again and more drastic treatment was undertaken. They kept making cars though sales did not justify their large production. They wanted to have as much of their stock as possible manufactured into cars at the time the halt came. Ford realized that so long as the company continued to buy materials, suppliers would continue to hold prices up. He saw that if lower prices were to be hastened, something drastic had to be done. So late in December he stopped manufacturing, resolving not to resume production until

[15] From an interview in the *Detroit News,* July 22, 1921, by James Swinehart, reprinted in the *Commercial and Financial Chronicle,* July 30, 1921.

he could buy materials at peace-time prices. Assembling went on at all the branches. In the meantime the business went through a thorough house-cleaning.

IV. THE SOLUTION—(B) FORCED SALE OF FINISHED PRODUCTS

When they closed down they had about 93,000 finished cars. Their first move was to sell some of the cars on hand. In their contracts with dealers, each dealer agreed to take a certain quantity each year, according to his district. They shipped to each dealer enough cars to take care of approximately twenty-five days' sales on SD/BL terms. During January they shipped nearly 60,000 cars, and from then on sales mounted above production. On January 23 they reopened the Highland Park plant and began building up production there. But sales still kept ahead of production. Between January 1 and April 1 they turned $27,700,000 worth of stock into cash.[16]

V. THE SOLUTION—(C) TURNING MISCELLANEOUS ASSETS INTO CASH

Then they began turning miscellaneous assets into cash. They collected outstanding foreign accounts and outstanding domestic accounts for sales of by-products. They also sold $7,900,000 of Liberty bonds. Altogether they raised $59,300,000—more than enough to meet their impending obligations.

VI. THE FOLLOW-UP—ECONOMIES IN TRANSPORTATION; REDUCING CASH TIED UP IN INVENTORIES; REDUCING OVERHEAD

But they didn't stop there. They got control of the Detroit, Toledo and Ironton Railroad and made changes in transportation of raw materials into the factories and delivery of cars to dealers. Where before $88,000,000 was tied up in moving and reserve stocks required to make 93,000 cars a month, they handled the stock required to make 114,210 cars a month for less than $60,000,000. Thus $28,000,000 went into cash account, to be used for other purposes—paying debts, for example.

They reduced the cash tied up in inventories by creating a system of inventory control. They figured out the exact amount of stock needed to make just the number of parts to fill the schedule of the cars to be produced each month and bought that amount of stock each month and no more.

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[16] The story of how Ford pushed his dealers is told in the *New York Times*, July 24, 1921, as follows:

Ford pushed his 125,000 surplus automobiles up the hill, off his inventory account and into the hands of 17,000 dealers. He shipped automobiles right and left all over the world to willing and unwilling consignees and drew against them.

Mr. Ford came East and found some $91,000,000 in "frozen" cars and parts in the New York, Philadelphia and Boston districts. Changes in personnel followed and others were threatened. The cars began to move out.

The case was reported of an Indiana dealer who had a floor full of Fords. His consternation was great when a trainload of cars, unordered, rolled into the city. His business future was at stake. He must, and did accept the draft. A former disgrunted Ford dealer with superior resources bought the trainload and startled the countryside by advertising a bargain sale of Ford cars.

In other cities and towns the dealers went to their banks and borrowed on the cars. Shipments averaged about one-tenth of a year's business. The unloading plan was a success, because it was economically sound. Agents were bluntly told that they were indebted to the Ford Company and that to prosper in the future they must assist now. Those who rebelled were removed. Those who accepted are today the strongest proponents of the Ford method.

They went through the offices and cut out hundreds of jobs created during the handling of war work. They cut the office force from 1,074 to 528 persons. Telephone extensions were cut about 60 per cent. They went through the shops the same way.

A comparison of operating costs before and after the house-cleaning proved a startling lesson in what manufacturers can do if they look sharp to economy. Before the house-cleaning, daily expense for labor and commercial overhead charges, cost of materials not included, averaged $465,200 to get out an average of 3,146 cars a day, or $146 a car. After the house-cleaning it took $412,500 a day to produce an average of 4,392 cars a day, or $93 a car.

Estimating Current Financial Requirements

Importance of estimating current capital requirements. Providing a business with cash when it needs it without carrying an excessive amount of current funds over the interim periods is a problem that should be faced like any other problem in business—first, from the angle of *planning;* then, from the angle of *doing*. The financial manager needs to know the amount, the timing, and the duration of the financial requirements. He can then plan to raise funds in the most appropriate way; he can have confidence in his ability to meet future obligations as they fall due; and he can avoid holding an excessive amount of idle cash. Financial planning calls for *forecasting and budgeting*.

In the rest of this chapter we shall consider, first, the application of these two key elements of financial planning to a small corporation. Then we shall define and classify forecasting and budgeting and show the relation between the two, and conclude with a discussion of cash budgets and financial reports.

Example of application of steps in financial planning. Successful businessmen apply the two key elements of financial planning to their businesses, often unaware that they are doing so. Let us see how this happens by pointing out the steps in financial planning and then showing how a small businessman builds up a profitable, expanding business by following these steps.

The major steps in financial planning include: [17]

1. Establishing the goals or objectives of the business.
2. Forecasting and measuring the conditions that affect the realization of the goals.
3. Budgeting and scheduling operations in terms of the forecast.
4. Controlling operations in line with the budget.
5. Appraising results, then modifying goals, the forecast, and/or the budget as may be required.

Our typical small businessman, let us say, is the successful president-

[17] From Allen H. Ottman, in *Corporate Treasurer's and Controller's Encyclopedia*, ed. Lillian Doris (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1958), Ch. 3.

manager of a men's furnishing store having an annual sales volume of $100,000 per year. He is convinced that the market he serves will permit him to doube the size of the store's operations over a five-year period. *That is his objective.* To accomplish this goal within five years, he will have to embark on a local advertising program to cost $5,000 per year, increase stocks of merchandise at the average rate of $5,000 per year, rent additional space at a cost of $1,200 per year, and add an additional clerk the first year and a second clerk the third year. To finance this additional cost, sales must increase at the rate of $20,000 a year over the five-pear period. Will business conditions be favorable enough to permit such sales increase? He knows that population in the area is increasing at the rate of 1,000 new families a year. He knows that the industries located in the area are prosperous, and he believes that they will continue to expand. He feels that the "economic climate" will be healthy for a number of years ahead. In other words, *the long-range forecast of conditions* that will permit the realization of his goal is favorable.

On the basis of these premises, he decides to go ahead with his plans for the first year. Using past experience and current style trends as a guide, he picks out the price lines, styles, and sizes that will sell best. He determines sufficient order quantities to maintain adequate stocks for servicing not only the present volume, but also the anticipated increase in volume. In doing so, he gives consideration to proper turnover, the time it will take vendors to supply him, and the amount of money the business can afford to tie up in inventory at one time. He bases his markups on competitive experience, some knowledge of his prospective selling costs, and a consideration of the amount of profit he can reasonably expect to realize from the anticipated sales volume. In fact, he has prepared a short-term forecast which, if acceptable, will become his *budgeted plan of operations* for the year in question.

As the year progresses, he watches his sales and profits by line, tries to discover the reasons for variations from expected performance, and attempts to correct any weak spots. In other words, he attempts to *control his operations to meet his plan.*

If results are unfavorable, he adjusts inventories, cuts costs, and changes his prices as may be required. Should conditions so change that he is *forced to modify* his long-range goal, he will make new estimates and new plans of operation.

Thus, this president-manager carries out essentially all of the steps of effective financial planning. But probably he would be the last man to admit that he operates his business according to the established procedures of financial planning or, as they are more narrowly applied in this chapter, to the established procedures of budgeting and budgetary control.

The foregoing example is a simplified one, but the basic principles and techniques described are applicable to all financial planning, whether for a small or a large, a simple or a complicated business structure.

Forecasting. Forecasting is the calculation of all reasonable probabilities about the business future. There are two types of forecasting: general and specific. Forecasting of general business conditions is based on an analysis of all the latest relevant information by tested statistical techniques, modified, revised, and applied in terms of experts' judgment and knowledge. General forecasting is done by government agencies, economists, banks, and the like. In specific forecasting, the businessman applies the general forecast in terms of his personal judgment and special knowledge of his own business to each phase of his business. The forecasting involves estimating the potential of an industry or a product and the trend of customer preferences, as well as a study of many other factors, such as business growth, national income, motives of people who buy, and the like.

There is almost no business or profession whose success or failure does not bear some relation to the general level of business activity. For the most part, the relation is quick and direct. If the general economy is in a slump, most businesses suffer. However, in rare cases, the relation may be reversed. One well-known example: Pawnbrokers are apt to do better in bad times than in good.

Forecasting the course of a business almost always involves some assumptions about over-all economic conditions. Only in the exceptional situation in which the performance of an individual business or industry invariably lags behind some general economic indicator is it possible to avoid the necessity of forecasting general business conditions.

Forecasting in use. The basic objective of forecasting a company's performance for the months or years ahead is to restrict the area in which guesswork or hunches are used. Today many companies have come to realize that the profit possibilities inherent in forecasting are worth the effort involved.

The degree of possible acuracy and the specific techniques of forecasting will vary, of course, from product to product, from firm to firm, and from industry to industry. For example, highly stable industries may be able to forecast future sales without too much attention to changes in economic conditions, just by analyzing industry trends, population growth, and regional population shifts. Similarly, sales of standard, long-established products are almost always easier to forecast than sales of less well-established items. Finally, the problems involved in forecasting sales of a completely new product are entirely different from those involved in the preceding instances.

A forecast may be short-term or long-term, depending upon the business. The length of time for which it is prepared should be determined by the needs of the business and how far ahead it is possible to forecast. Public utilities forecast ten or 15 years ahead; other companies usually forecast two years ahead.

Budgets. The term "budget" is derived from the French word *bougette,* meaning a leather pouch, in which funds for anticipated expenses are set aside. And that, in effect, is the purpose of a budget—to have funds on hand with which to meet expenses. In general, a budget is an estimate of the future activities of a business, especially of its resources and expenditures, over a given period of time. Budgets rarely are projected for more than a year in advance, except in the case of capital assets, and often are projected for only three months. The control of a company's income and expenses and of changes in its capital assets and liabilities by means of a budget program is known as *budgetary control.*

The steps in budgeting and budgeting control follow: First, forecasts are made of probable income and expenditures over a relatively long period of time. The period varies with the nature and needs of the business. Second, approved budgets or plans of operation based in a large measure upon the forecasts are established. (The budget period is usually shorter than the forecast period, generally one year, in order to achieve greater accuracy in planning over the near term and to obviate the necessity for frequent revisions of the budgets themselves.) Third, statistics of actual performance are compiled at stated intervals during the budget period and they are compared with the budget allowance. Fourth, variances of actual from budgeted performance are measured and the reasons or causes of the variances are analyzed. Fifth, the necessary corrective action to be taken to reduce or eliminate the cause of the variance is determined and the proper persons are authorized to institute the corrective action. The decisions are followed up to see that the agreed-upon action is taken and results achieved.

Relation between forecasting and budgeting. In order to understand the relation between forecasting and budgeting, the reader should keep in mind the distinction between them. From the foregoing discussion, it is evident that forecasting determines *whether and to what degree* the future programs of a company are feasible. After the goals of the business are set, the budget programs exactly how and when they will be achieved. The budgets determine in detail how the company must operate over a limited time to realize the portion of the comparatively long-range program that can be accomplished within the budgetary period. Budgets are based on forecasts. As indicated in the preceding

paragraphs, forecasting is a preliminary to budgeting; without forecasting, a reliable budget cannot be prepared.

Forecasting and budgeting together assist a business in maintaining a sound, healthy condition: (1) They are a means of detailing and formalizing the plans and developments of each segment of the business, and (2) they coordinate the plans of all segments of the business.

The budgets included in budgetary control. A complete budget system requires the preparation of a number of separate budgets and the formation of a composite financial budget. We shall describe briefly some of the principal individual budgets that would be prepared in a manufacturing company that operates under a comprehensive budget system, and show the importance of each. It must be remembered, however, that there is no single budget program that will most effectively fit the particular needs of any business. A budget program, to achieve maximum results, must be tailor-made to fit the particular needs of the business.

The *sales budgets* constitute the basic foundation upon which the budget program is constructed. Only if the sales budgets of the various classes of products sold are correctly stated in terms of unit and dollar volume which can be realized during the budget period can budgets of cost and expenditures necessary to realize the budgeted sales volume be developed on an accurate and effective basis. The *cost of sales budget* establishes the margin yield on the various classes of products to be sold. The *inventory increase or decrease budget* shows what increases and decreases are necessary in inventory each month. The *production budget* shows how much of each item is to be produced each month. The *direct materials budget* shows how much raw materials are required to produce the budgeted production. The *direct labor budget* shows the amount of direct labor cost necessary to service the budgeted production. The *selling expense budget* sets forth the allowable departmental selling expenses. The *advertising expense budget* covers the cost of operating the advertising department and the cost of the individual advertising programs. The *administrative expense budgets* are prepared by departments according to the individual administrative expense accounts to be borne by the departments. The *profit and loss budget* is constructed by posting the annual budget data from the various other budgets that have been prepared: sales, cost of sales, selling, advertising, and others. The *capital expenditures budget* is developed from studies of necessary replacements of, and necessary additions to, present property and equipment within the ensuing budget year. Capital expenditures budgets are geared to the long-range plans and programs of the company. (We shall treat this subject more fully in the chapter on expansion.) The *cash budget* compares the estimated

cash income with the estimated cash disbursements of the company over the budget period and shows the resultant monthly cash position as the budget period develops. Because of the importance of the cash budget in the control of working capital, it will be discussed more fully at pages 311 *et seq*.

Administration of the budget program. The administration of the budget program should rest with a major corporate executive. He may be the controller, the treasurer, or the financial vice president. The budget executive does not prepare the forecasts of sales, establish cost objectives, or prepare the various budgets. These activities are the province of the executives and department heads who prepare the individual budgets. The budget executive is responsible, however, for the budgets of departments directly under him, and for the financial budgets. Briefly, the budget executive in a medium-size company is responsible for the following functions:

1. The preparation of all instructions necessary to effect the budget program. These instructions may be in the form of individual letters to the responsible executives and department heads, or in the form of a manual.

2. The furnishing of all data relative to past operations that may be required by those responsible for the preparation of the individual budgets.

3. The consolidation of individual budgets into a complete budget program for submission to management.

4. The preparation and distribution of all performance reports necessary to keep management advised of the extent to which the budget program is being attained.

5. The recommendation of prompt revision of the budget whenever circumstances indicate that revision is required.

When the budget program is first installed, the function of interpretation of budget reports, analysis of reasons for variation from the budget, and correction of conditions leading to variations are also the responsibility of the budget officer. As the budget program develops, much of this responsibility will be assumed by those executives responsible for the variations that have taken place. Summary explanations to top management may still rest with the budget officer.

Upon the basis of reports from the budget officer, management is able to compare actual results with expected results, and to make whatever adjustments appear necessary or advisable in the light of conditions prevailing at the time. Only in cases where an extreme variation or change in selling prices, material or labor costs develops within the budget year, should a revision of the basic yearly budgets be necessary. Experience proves that frequent revision of basic yearly budgets is fatal to the budgetary system. Not only are the end goals upon

which the budgets were originally based forgotten and no attempt made to co-ordinate toward the best solution of a common task, but even those charged with preparing and administering the budget itself grow complacent and lose interest in the program. Finally, no divisional head is held accountable for his performance and no one particularly cares how those whom he supervises perform. When this point is reached, the usefulness of the budget is destroyed.

Knowing the cash position. In order to manage current finances properly, it is necessary that the managers know approximately how much cash may be expected from day to day, week to week, and month to month. They get this information from the cash budget and from financial reports. The financial reports will be examined after the cash budget and the cash budget report have been described.

The cash budget. The cash budget compares the estimated cash receipts with estimated cash disbursements of the company over the budget period and shows the resultant periodical cash position as the budget period develops. The cash budget is more than a mere mechanical assembly of cash estimates. Preparation of it involves translating the forecasting operations of the business into the effect of these operations upon the cash balance of the company. Hence, before the specific cash receipts and disbursements can be estimated, it is essential that there exist realistic and detailed forecasts of sales, production, purchases of materials, purchases and sales of capital assets, and other operating plans. Useful financial projections cannot be made without reliable forecasts of operations.

Construction of cash budget. Cash budgets are prepared in various forms. A standard form showing the sources of cash receipts and disbursements in fairly complete detail is shown on page 313. The extent of the detail can be varied to suit individual requirements. The type of budget illustrated is recommended because it furnishes a complete cross section of cash activity for the entire budget period.

The estimate of cash receipts is principally the prediction of amounts that will be received through customer payments. In order to make the estimate, the forecast of sales must be converted into collections of accounts receivable by applying a projected collection period to the sales forecast. For example, if the projected collection period is 30 days, the estimated collections for a particular month would equal approximately the sales forecast for the preceding month. Of course, allowance, based on the company's past collection experience, should be made for slow and uncollectible accounts.

Other income receipts, such as dividend income, note and interest payments received, cash sales, and the like, which are normally of a minor nature in a manufacturing company, are estimated and earmarked exactly to the month of receipt.

The accurate budgeting of the cash disbursements is more difficult. There are a great variety of items, and many of the disbursements do not coincide with calendar months and are not uniform from one calendar month to another. Based upon studies of the spread between purchase and payment dates for direct material, indirect material and supplies, capital equipment, and so on, the required purchases of these items by month may be translated into required payments by month. The required payments for wages, salaries, taxes, insurance, dividends, and other disbursements are added to the respective payments for purchases to arrive at the budget of cash disbursements by months.

The "net change in cash," "cash at the beginning," and "cash at the end" items shown on the illustrated cash budget form are merely mechanical calculations. The net of the budgeted cash income and the budgeted cash disbursements by months is the amount of the budgeted cash gain or loss by month. When this figure is added to (or subtracted from) the budgeted cash balance at the beginning of the month, the budgeted cash balance at the end of the month is obtained.

The amount of cash required to be on hand at the end of each month is based upon the total cash requirements of the company in the month following, plus consideration of the timing of receipts and disbursements during such month. For example, if receivables are not usually collected until the 15th of the month, two full weekly payrolls will have to be met before there is any appreciable increase in the cash balance. The cash problem would be even more difficult if payment for raw materials had to be made by the 10th of the month, possibly as a result of E.O.M. discount datings on purchases. Only by consideration of such factors can management intelligently estimate the amount of cash required at the beginning of the month to finance operations during the month.

If cash requirements exceed "cash at the end," there is a cash deficiency and a borrowing need is indicated. The cumulative cash deficiency is a measure of borrowing needs throughout the entire budget period.

Usually monthly budget periods are satisfactory, but if the bulk of the company's disbursements come early in the month whereas receipts are spread relatively evenly throughout the month, there would be an intra-month cash-need peak that would not be revealed by a monthly budget. In such cases, budget periods short enough to indicate the maximum cash strain should be chosen.

In constructing a cash budget, it is essential to differentiate between the accrual of income and expense, in an accounting sense, and receipts and disbursements of cash. For example, credit sales anticipated in January and expected to be collected in February would appear as

FORM OF CASH BUDGET

	January	*February*	*March*	*First Quarter*
Cash Receipts				
1. Charge sales	$	$	$	$
2. Cash sales				
3. Notes receivable				
4. Disposal of fixed assets				
5. Interest on investments				
6. Profits remitted by subsidiaries ..				
7. Proceeds of loans				
8. Other				
Total Receipts	$	$	$	$
Cash Disbursements				
1. Materials	$	$	$	$
2. Wages				
3. Salaries				
4. Supplies				
5. Taxes				
6. Other expense				
7. Capital items				
8. Income taxes				
9. Interest on debt				
10. Dividends on stock				
11. Payments on loans				
12. Other				
Total Disbursements	$	$	$	$
Net change in cash	$	$	$	$
Cash at the beginning				
Cash at the end				
Cash required				
Excess (Deficiency)				

income for January in a projected income statement. However, they would not be reflected in the cash budget until February, when it is expected that the cash would actually be received. Similarly, purchase payments entered in the cash budget would lag behind scheduled purchases, if deferred payments were made in accordance with the terms of sale. Certain items of expense that appar in an income statement would not be reflected in the cash budget at all. These are non-cash expenses, for which there is outlay of cash. A prominent example is depreciation. On the other hand, an investment of cash in another form of asset takes cash out of the business but does not affect the income statement. From the standpoint of a cash budget, we are interested only in the actual receipts and disbursements of cash.

The cash budget report. As previously indicated, a budgetary system calls for reports on each of the prepared budgets. A cash budget report provides a period comparison of actual cash income and expenditures

by account or account group with budgeted cash income and expenditures. It shows the variance in both dollars and per cent, and indicates actual versus budgeted cash balance at the end of the period. Ordinarily, a revised projection of the cash forecast, covering the ensuing three or six months, is included as a part of the cash budget report. A form of cash budget report is shown at page 315.

Financial reports concerning working capital. The danger of embarrassment or even catastrophe from lack of working capital is so great that the executives of a business, large or small, must keep themselves well informed on its present and prospective cash positions. The prospective position is handled through the preparation of the various budgets previously referred to. The present position is shown and controlled through the preparation of financial reports, varying in form and number with the size of the company and the nature of the business. The most important reports that show management the working capital position of the company are described briefly below.

1. *Cash report.* It is customary, in many businesses, for the treasurer, and in most cases the president, to receive daily a summary of receipts and disbursements, made up from the cash receipts records and check registers (disbursement records), or from the general cash book. A form that is useful for this purpose is given at page 316. The inclusion in this form of the total amount of outstanding accounts receivable and of current liabilities provides a daily statement of the net quick asset position of the company. In companies that have adopted modern techniques of cash budgeting, a weekly cash report may be sufficient.

2. *Accounts receivable report.* The primary purpose of this report is to show the realizable value of the receivables and to control credit and collection policies. The report shows the total amount of receivables that are current, and the totals 30 to 60 days old, 60 to 90 days old, and more than 90 days past due date. In some companies, the report also includes the amount of reserve for bad debts, together with the additions to the reserve and the details of charges against the reserve for the period. This report is prepared monthly, but if the amounts are numerous and the amount of work involved in aging them is large, it is made up quarterly.

3. *Inventory analysis.* An important report to reflect working capital position is a detailed analysis of the make-up of the inventory. This report usually presents a comparison with the previous month-end, beginning of the fiscal year and, at times, comparable figures for the previous year. Companies that produce for, and ship from, stock, usually include the rate of inventory turnover, or the number of days' supplies on hand, for each of the major classifications of finished goods, and in many cases of basic raw materials. In the case of trading com-

panies, wholesalers, jobbers, and related groups, the report of inventory balances, commitments, and inventory turnover is possibly the most important report for purposes of managerial control and a daily preparation of the report is not unusual.

XYZ CO. Form 562 (Figures in 1,000's of Dollars) CASH BUDGET REPORT PERIOD 9 ENDING (SUNDAY) September 30, 19--

ITEM		CURRENT PERIOD ACTUAL	BUDGET	OVER OR UNDER	%	PERIOD NUMBER AND DATE ENDING 10 Oct.10	11 Nov.7	BUDGET - BY PERIODS 12 Dec.5	13 Jan.2	1 Jan.30	2 Feb.27	NOTES
Net Debits to Accts. Rec. (Memo)	1	504	522	*18*	*3*	571	591	575	573	564	553	
	2											
Collections from Accts. Rec.	3	492	516	*24*	*5*	506	573	625	675	503	578	
	4											
	5											
	6											
	7											
Net Hourly Payroll	8	203	199	4	2	208	287	235	227	222	224	
Net Salary Payroll	9	61	61	-	-	61	61	61	62	62	62	
Federal & State Unemployment	10	-	-	-	-	-	10	-	-	21	-	
Federal Old Age Tax	11	-	-	-	-	-	18	-	-	18	-	
	12											
Raw Material Purchases	13	49	57	*8*	*11*	62	24	39	32	34	28	
	14											
Direct Supplies	15	44	36	8	22	48	52	51	51	51	51	
Indirect Supplies	16	57	49	8	17	67	63	64	63	63	61	
Freight	17	9	10	*1*	*10*	10	10	10	10	10	10	
Selling & Administrative Expense	18	21	23	*2*	*9*	24	25	24	25	22	22	
Capital Equipment Purchases	19	9	12	*3*	*25*	35	19	6	14	8	5	
Insurance	20	5	4	1	25	2	24	-	3	1	7	
Taxes	21	1	1	-	-	56	9	1	48	1	1	
Other Operating Disbursements	22	4	2	2	100	2	2	2	91*	2	2	*Employee Bonus
Total Operating Disbursements	23	463	454	9	2	575	604	493	626	515	473	
	24											
Net Operating Cash Change	25	29	62	*33*	*53*	*69*	*31*	132	40	*12*	105	
	26											
Royalty Income	27	4	3	1	33	3	3	3	3	3	3	
Interest Income	28	-	-	-	-	4	-	-	4	-	-	
Dividend Income	29	-	-	-	-	35	-	-	-	25	-	
Sale of Investments, Property, etc.	30	-	-	-	-	-	14	-	-	-	-	Sale-Tenant House
Other Non Operating Income	31	-	1	-	-	1	1	1	1	1	1	
Total Non Operating Income	32	4	4	-	-	43	18	4	8	29	4	
	33											
Investments Acquired	34	52	52	-	-	-	-	-	-	-	-	Purchase-U.S Treas
Interest Payments	35	12	12	-	-	-	-	12	-	-	12	Notes
Note & Loan Retirement	36	-	-	-	-	20	-	-	20	-	-	
Dividends Paid	37	-	-	-	-	26	-	-	26	-	-	
Other Non Operating Disbursements	38	3	2	1	50	2	2	2	2	2	2	
Total Non Operating Disbursements	39	67	66	1	2	48	2	14	48	2	14	
	40											
Net Cash Change	41	*34*	-	*34*	-	*74*	*15*	122	9	15	95	
	42											
Previous Cash Balance	43	526	526	-	-	492	418	403	525	534	549	
	44											
New Cash Balance	45	492	526	*34*	*6*	418	403	525	534	549	644	
	46											
	47											
# Company operates on a 13-period	48											
calendar.	49						Prepared by R. Jones, Budget Supervisor					
	50								September 22, 19--			
Italicized figures appear in red.	51											
	52											

4. *Report of working capital.* The frequency with which this report is issued depends upon such factors as how often the company prepares a balance sheet and how strong its working capital position is.

DAILY CASH REPORT

DATE: March 15, 19. .

Bank	*Opening Balance*	*Deposits*	*Disburse-ments*	*Closing Balance* — *Today*	*Closing Balance* — *1st of Month*
Bank A	8,769.51	2,571.39	6,129.38	6,211.52	12,520.31
Bank B	1,000.00				
Total	9,769.51	2,571.39	6,129.38	6,211.52	12,520.31

REMARKS:

	This Day	*This Month To Date*
Disbursements		
Material and Expense	573.22	2,292.88
Payroll:		
Factory	3,171.20	32,260.17
Office	420.30	2,081.50
Capital Additions	—	—
Taxes	1,871.52	1,871.52
Dividends	—	—
Other	93.14	350.20
	6,129.38	38,856.27

Quick Assets	*Today*	*1st of Month*
Cash	6,211.52	12,520.31
A/cs. Rec.	12,450.28	20,230.90
Total	18,661.80	32,751.21
Less Current Liabilities	3,520.12	8,461.39
Net	15,141.68	23,299.82

A company that prepares monthly or quarterly balance sheets will usually include the working capital report as a part of the balance sheet report. A company that is suffering from inadequate working capital will need a weekly report of working capital. Usually, a monthly report is adequate. The various current assets are listed separately as well as the current liabilities and the amount of working capital. Comparisons are given with the previous month-end, and, in cases where there is a regular fluctuation of working capital during the month, comparison with the same data for the preceding month is often included.

Research Question

What is the current cost of raising current capital through:

(a) Unsecured bank loans.

(b) Assignment of accounts receivable to company.

Problem

The Eastman Manufacturing Corporation finds that the production cost on the new machine it plans to produce will amount to $80 per unit. Selling and administrative expense will amount to $25 per unit. The company plans to sell the product for $125 per unit, and produce 200 units the first month, 300 the second, 400 the third month, 500 the fourth month, and 600 each month thereafter. Terms of sale will be 2/10 net 30 E.O M. and it is expected that half of the purchasers will take advantage of the discount and the remaining half will pay on the due date. How much current capital will the company need?

CHAPTER 16

Financing Current Operations

Temporary capital needs. In the preceding chapter the nature of current capital was described and the elements determining the amount needed in any business were outlined. It was pointed out that all of the initial working capital should be obtained through the permanent investment of the owners, and that the regular or permanent working capital should be raised through permanent investment of the owners or through long-term borrowing. Permanent investment of owners includes, in the case of an established business, reinvested or plowed back earnings.

Temporary current asset needs are ordinarily met by short-term borrowing. At times corporations have sufficient working capital from other sources and do not have to resort to short-term loans. For example, when working capital had to be expanded at the close of World War II in order to restore business to normal peacetime channels and to meet the rising costs of goods and services, corporations not only borrowed for short terms but they also sold their government security holdings and used retained earnings and other internal funds. Also, those companies that raised capital in the securities markets by selling stocks or bonds, or that made long-term loans at banks, often used part of the proceeds of these funds as working capital.

Although most current funds are needed to finance the purchase of goods that are ultimately to be sold and thus converted into cash with which the debt can be paid off, temporary needs for cash can arise for other reasons. Thus, a company may be short of funds to meet interest payment on a bond issue because sales fell off as a result of strikes, recession in business, or other developments. It may need funds temporarily while its program for long-term financing is being arranged. In the following explanation of the sources of funds for current capital and the methods of obtaining the funds, attention will

be given to the suitability of the various types of financing for different purposes.[1]

It must be noted that the various types of loans described in this chapter do not augment working capital, as we define it, although they are sources of cash. If a company sells accounts receivable, it increases its cash without increasing its working capital, for in effect it merely exchanges one form of circulating capital for another. In the same way, a short-term loan from a bank increases cash, but does not increase the working capital, for at the same time that cash is increased there is added to the current liabilities the item of bank loans. On the other hand, working capital may be increased by a sale and lease back arrangement, for example (see page 435), and this method of financing is now often used to obtain funds for current needs.

Sources of Current Credit

Classification of sources. The usual sources of current credit are:

1. Trade creditors.
2. Commercial banks.
3. Commercial finance companies, including factors.
4. Commercial paper companies.
5. Other sources: Small Business Administration and Federal Reserve Banks.

Discussion of each follows.

Trade creditors. The most common and most frequently used source of current business credit is trade creditors. Those who sell merchandise or services to business concerns are customarily willing to extend reasonable short-term payment terms, either as a matter of custom or convenience or as an inducement to the sale. Because of the margin of profit involved in each transaction, and because of the prospects of subsequent transactions of the same kind, trade creditors may be willing to take a moderately greater risk in the extension of credit than a bank or other lending agency.

But a trade creditor, too, must have reasonable assurances of the integrity and ability of business management, and of the financial condition and prospects of the business, before he can be expected to part with his merchandise or services upon the strength of an understanding that payment for such purchases will be made at a later date. By using the services of credit agencies, such as Dun &

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[1] The discussion that follows is based partly on the chapter "Financing Working Capital Needs" by Edward F. Gee and the chapter "Seeking and Obtaining Short-Term Credit" by Theodore H. Silbert and Robert Andrew Klein, in *Business Finance Handbook*, ed. Lillian Doris (Englewood Cliffs, N J.: Prentice-Hall, Inc., 1953).

Bradstreet and the National Credit Office, and by exchanging actual customer ledger experiences the trade quickly becomes familiar with the status of a firm's relations with its creditors. After a good credit relation has been established, should conditions warrant it, larger credit lines may be sought from suppliers, or more liberal terms than those usually offered can be negotiated.

Cash discounts. In our discussion of the advantages of ample working capital, on page 292, we explained cash discounts. The terms of cash discounts have a pronounced effect on the use of trade credit. It is a fundamental principle in good business management that, under no circumstances, should an available cash discount on a purchase be lost through failure to pay for the purchase within the specified cash discount period.

To illustrate, assume the purchase of merchandise for $1,000 on terms of 2/10, net 30. If payment is made within ten days, a cash discount of 2 per cent may be deducted from the amount of the invoice and the obligation may be discharged in full upon the payment of $980. If payment is not made within ten days, the full amount of the invoice, $1,000, must be paid, in any event, within 30 days. Thus, for the use of the $1,000 during this additional period of 20 days, the business loses the $20 cash discount. To use $1,000 for 20 days at a cost of $20 is at a cost rate of $1 a day or $365 for a year of 365 days. Therefore, for the use of the $1,000 for the 20 days, the business pays at an annual rate of $365 or 36.5 per cent of the amount involved. Since the maximum legal rate of interest or discount that may be charged by a bank on a bank loan, in most states, is 6 per cent per annum, it is obvious that a business would be foolish indeed to lose a cash discount on a purchase if it could obtain a bank loan at an annual cost rate, in the illustration cited, less than one-sixth as great.

Commercial banks as a source of current funds. The average industrial or mercantile concern relies chiefly on the commercial bank for assistance in meeting the demands of variations in cash requirements. Sometimes several banks are used, especially where plants are maintained and important selling operations are conducted in different localities. No businessman can call himself competent who does not understand the principles on which banks operate and especially those principles that govern the extension of credit to customers by banking houses.[2]

The kinds of loans that a business can seek from its bank to finance current operations are discussed under Current Financing Methods, beginning at page 327. Here, we shall discuss briefly the following

[2] See R. G. Thomas, *Our Modern Banking and Monetary System,* 3rd ed. (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1957).

related subjects: (1) significance of borrowing from a bank, (2) choosing a bank, (3) bank balances, and (4) negotiating a loan.

Significance of borrowing from a bank. The businessman who needs to borrow from a bank must know that he and his business are to be subjected to searching inquiry. The consciousness of that examination stimulates efficiency. Indeed, recourse to bank loans is a tonic. When a corporation borrows from a bank, the bank watches its financial operations with great care and frequently makes suggestions that are of inestimable value to the general welfare of the corporation. Such suggestions may take the form of a warning that a dividend should be passed, or that a bank loan should be increased in order that the corporation may take greater advantage of trade discounts. Then, too, using a bank's facilities makes a favorable impression on supply creditors; the latter are usually more ready to be liberal with customers who regularly borrow from a bank, for they know that the bank loans could not have been obtained if the customer had not met successfully the bank's investigation.

The business house must select its bank carefully, establish its right to loans, and keep its credit good by conducting its business properly and giving the bank full information on how its business is being conducted.

Choosing a bank. The needs of the business must be matched against the facilities of the bank. If the company is likely to need large credit lines at certain periods of the year because of seasonal fluctuations, it will select a bank whose typical customers receive loans of a size comparable with the company's needs. If the firm is engaged in import and export trade, it will want a bank that is equipped to handle foreign exchange and letters of credit. If it wants to borrow on field warehousing agreements, or other special credit instruments, it will select a bank that can and will handle such types of loans. In addition, it will consider the attitudes of the directors and officers of the bank. The ultra-conservative bank may have too stringent a credit policy; the bank with an aggressive new-business policy may be lending too close to its limits and thus be unable to help its old customers in times of general business stress. Such factors as convenient location, facilities for safe deposit boxes, collecting coupons, payroll and other special services may also have to be given weight.

Bank balance. The rule that a foundation for maximum bank loans must be laid by maintaining a deposit balance equal to from one-tenth to one-fifth of the maximum loans, depending on circumstances, used to be generally observed. This so-called "compensatory balance"—a balance to compensate for credit lines or loans—was intended to indicate strength and to influence the bank in making a loan whenever

it might be requested. The rule lost most of its force while easy credit conditions prevailed. Obviously, banks like to have borrowers keep their regular business checking accounts with them. And companies that are likely to need bank credit select a bank for regular checking account service where they can apply for and obtain loans. Furthermore, it improves the banking relationship to keep the deposit with the bank that provides credit. Hence, most companies have balances at banks from which they make loans. Generally the compensating balance equals 10 to 20 per cent of the loan when the corporation is borrowing, but may be less between loans.

Negotiating a loan. In negotiating a loan with a bank, the businessman must make his request, meet the bank's test of credit standing, and be prepared to give assurance that the loan will be repaid. The request for a loan is ordinarily made by the financial officer of the corporation. The loan officer of the bank will give the applicant a "statement form," which contains a blank form of balance sheet, income statement, and a number of questions relating to items in the financial statements and other matters pertaining to the business.

Among other things, a commercial bank will usually want to know three things about each loan request it receives:

1. The purpose or purposes for which the funds are needed.
2. The plan of repayment.
3. The source or sources of repayment.

All three are closely related. If the purpose of a loan is to free cash for operating needs that is tied up in an account receivable, repayment may be scheduled shortly after the account is expected to be collected; the source of repayment will be the reduction of receivables. If the purpose of the loan is to purchase seasonal merchandise, to be converted into receivables and then into cash, repayment may be scheduled for the completion of the cycle; the source of repayment will be the seasonal reduction of trading assets. These are examples of desirable, self-liquidating, commercial bank loans. Other loan needs, even for current capital purposes, may be dependent upon other, less definite, sources of repayment.

If, from its investigation, the bank is satisfied that the company will be able to liquidate the loan, it may grant the loan on the company's plain promissory note. If it has any doubt about the management of the enterprise, or if there are signs of financial weakness, the bank may propose a loan agreement. The promise to repay is contained in a plain note, but the agreement that accompanies it gives the bank greater assurance that the financial strength of the borrower will be maintained. This assurance comes from provisions in the agreement that restrict or limit the financial policy of the borrower.

For example, the agreement may limit dividend payments and even salaries; it may require that a certain minimum of working capital be maintained and that no further borrowing be undertaken. Revolving loans, which will be discussed later in this chapter, and term loans, which will be discussed in Chapter 21 because they are also used extensively for purposes other than strengthening working capital, are usually made under loan agreements.

When the credit standing of the applicant does not justify an unsecured loan, the bank may ask for collateral. It may also ask for collateral if the purpose of the loan is to carry assets of a type that can be pledged conveniently. (See *inventory financing,* page 334.) A firm that does not have sufficient financial strength to get an unsecured loan and that does not have collateral to offer may still be able to make a bank loan provided it can get someone with adequate financial responsibility to become a co-maker on the note, or an endorser or guarantor. The accommodation gives the bank the right to look to the borrower and the co-maker, endorser, or guarantor for payment. A weak corporation, for example, may obtain a bank loan on the guaranty or endorsement of its note by one of its wealthy officers; a weak subsidiary may get bank credit because a strong parent corporation has agreed to stand behind the debt.

Finance companies. When a business is unable to qualify for unsecured bank credit, or for secured credit on a basis, to an extent, or for a period acceptable to it and its bank, it should explore the possibility of working out financing arrangements with a finance company. Finance companies may be classified as (1) *commercial finance companies* and (2) *sales finance companies,* although many companies function in both capacities. All are engaged in granting self-liquidating collateralized credit. Through specialized knowledge and techniques, and willingness to take risks, they can supply funds that often cannot be obtained through other channels. They have pioneered in the development of new forms of lending, some of which have been perfected to the point where more conservative lenders, like banks, now employ them. Their ability to take risks also lies in thorough screening and detailed supervision of accounts and the charging of somewhat higher rates to compensate for the overhead arising from multitudinous bookkeeping transactions and for losses. Thus, through good organization and initiative in using new techniques, these finance companies have become a vital part of the credit system of the United States.

Commercial finance companies. Financing arrangements with a commercial finance company usually involve the sale or assignment of accounts receivable or the pledge of inventories, or both. Periodical liquidation is not usually required and loans outstanding may be

fairly continuous over long periods against revolving security, until the borrower has built up its own capital funds sufficiently, through earnings or otherwise, to enable it to qualify for seasonal bank financing on an unsecured basis.

The commercial finance industry is marked by a wide variation in the characteristics of companies that comprise it, especially as to their sizes, functions, and methods of operation. These variations exist because the industry is young as compared with commercial banks, and has developed from pioneering efforts in new financing techniques. A handful of very large companies, some with branches throughout the country, engage in several types of financing. At least one large company engages in every type of financing. There are over one hundred medium-size companies, each with capital, surplus, and debentures of over $1 million. Although they specialize more than the larger companies in particular types of financing, they offer the efficient handling of a wide variety of credit services. Finally, there are from four to five thousand smaller companies, many located outside metropolitan areas, which often specialize in one or two types of financing. They are generally willing to undertake more bookkeeping details and consequently require increased compensation. They give personal attention to small business clients that are not of sufficient size to be handled profitably by larger companies.

Sales finance companies. Sales finance companies specialize in discounting conditional or installment sales to consumers. They generally also engage in trust receipt financing, which is sometimes called "floor planning" or "wholesale financing" (see page 337). They thus offer a well-rounded financing plan to a dealer in consumer durables by financing his inventory through trust receipts, and his receivables through discounting conditional sales. Chattel mortgage companies, which are generally small companies, specialize in loans against existing machinery and equipment.

A *factor* is a specialized type of privately owned sales finance company that engages in the business of purchasing accounts receivable without recourse on the seller for credit losses. Each debtor is notified that his account has been sold and he makes his payment directly to the factor. The credit risk on all merchandise sales is assumed fully by the factor, which approves each credit in advance, before the merchandise is shipped.

In addition to purchasing accounts receivable, billing, ledgering, and collecting the receivables, and guaranteeing the seller against customer credit losses, the factor may also extend credit to its clients against merchandise on hand or in process of manufacture, against liens on plants or machinery, or on an open-note, unsecured basis.

Companies that use the services of finance companies. If the business applying for credit can show that it is well managed and has good profit prospects, commercial finance companies will give the application serious consideration. Of course, it must have sufficient net worth, working capital, and earning power to ensure that it can stay in business and operate successfully. Also, it must be able to offer acceptable accounts receivable. Companies that use the services of commercial finance companies often fall into the following categories:

1. A young under-capitalized company that does not have sufficient working capital at the time of application but expects in the near future to increase such funds through larger sales volume and retention of earnings.
2. A growing company whose increased sales volume has temporarily over-extended its working capital resources.
3. A company whose working capital has been depleted by adverse business conditions, which have since then been corrected.
4. A company whose capital has been reduced through a change in capital structure, such as the buying out of a principal.
5. A company whose management lacks experience in its present venture but has high character and ability and can present sound collateral for secured financing while it improves its management.
6. A company in an industry with large seasonal peaks, such as the bathing suit, winter outerwear, and sporting goods industries.
7. A company that for other reasons does not meet the technical requirements for a bank loan; its progress is retarded by lack of working capital, but it possesses acceptable accounts receivable or other security.

Commercial paper houses. Large, nationally known industrial and mercantile concerns can raise working capital by borrowing from banks in all parts of the country through the medium of commercial paper houses.[3] The commercial paper house either acts as a broker between the company issuing the notes and the purchaser of the notes, or it buys the paper from the issuing company as a dealer and then sells it. Through the open market, banks are able to invest their surplus funds in seasons when borrowing is slack in their locality. For example, in the cotton country, there is very little borrowing from November to March. During those months the banks in that territory invest their

[3] Buying and selling commercial paper may be only one of the functions of a large financial institution that does other types of financing. For example, Salomon Bros. & Hutzler, which has a commercial paper department, also acts as stock broker, securities dealer, and investment banker.

surplus funds by buying in the open market the notes issued by merchants in other parts of the country.

The commercial paper house makes a profit by selling the paper to purchasers, who are for the most part banks,[4] at a lower rate of discount than that at which it purchased the paper. Commercial paper sold in this way is used for seasonal and emergency circulating capital, and for periodically furnishing funds to close out loans at a company's own bank or banks. It may also be used to meet interest payments and for interim financing while long-term financing is being arranged.

Small Business Administration. The Small Business Administration, the first peacetime independent governmental agency created solely to advise, assist, and protect small businesses, came into existence on July 30, 1953. Among its functions is the power to furnish credit either (1) as a maker of a direct loan to a business concern, or (2) as a guarantor, in part, of a loan made by a bank to a business concern. Credit from this source is available, however, only if it can be established upon investigation that the business is entitled to credit but is unable to obtain its requirements from normal financing sources. Usually, a loan application must have been considered and declined by one or two commercial banks before it will be considered by the SBA.

Loans made or guaranteed by the Small Business Administration may be used for any essential business purpose such as current capital, plant improvements or additions, and must be secured by acceptable collateral, such as assignment of accounts receivable, pledge of inventory, and mortgage on fixed assets. Repayment terms are usually on an installment basis and may extend from five to 20 years depending on the type of loan.

The effectiveness of the Small Business Administration as a source of funds for small businesses has been increased by the Small Business Investment Act of 1958. The Act seeks to make it easier for small business concerns to obtain much-needed long-term financing and equity capital. It does this by setting up a program of federal help for privately financed small-business investment companies and local development corporations, which have paid-in capital and surplus of at least $300,000. These companies are authorized to furnish equity capital to small-business concerns through the purchase of convertible debentures. The SBA can make loans to these investment companies of up to $150,000 through the purchase of subordinated debentures.

Under this program there is no direct contact between the Federal

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[4] Commercial paper is considered a prime short-term investment. Banks find it an ideal investment; the losses suffered by banks through the purchase of such paper have been negligible.

Government and small business concerns. Instead, small firms seeking long-term financing or equity capital deal directly with these private lending organizations.

The Act also repeals the Section 13b lending power of Federal Reserve banks—a power seldom used in recent years.

Current Financing Methods

Classification of financing methods. Now that we are familiar with the various types of institutions that finance current operations for business concerns, let us consider the methods of current financing that may be available to a business through the lending institutions. The various methods used by corporations may be classified as follows:

1. Unsecured loans.
2. Sale, discount, or pledge of notes or contracts receivable.
3. Sale or assignment of accounts receivable.
4. Assignment of funds under performance contracts.
5. Inventory financing.
6. Liens on fixed assets.
7. Pledge of stocks and bonds.

Unsecured loans. The most desirable and most economical method of financing current operations is through *unsecured loans*. The corporation whose management, past operating record, financial condition, and future prospects, are sufficient to enable it to borrow from its bank on an open note basis enjoys a financing advantage that should be carefully protected and maintained. Actually, the term "unsecured" is a misnomer, for, strictly speaking, a good unsecured loan is adequately secured. The borrower does not pledge collateral, but he presents a balance sheet, an income statement, and a past credit record as the basis for the loan. The loan is not unsecured in the sense that there is no assurance of payment, for it is in reality secured by the entire business and its unpledged assets. Furthermore, an unsecured bank loan is partly secured by the compensating bank deposit; through the rule of offset, a bank may hold a debtor's assets as an offset against the amount owed.

Borrowing procedure. A variety of procedures exist in connection with notes that are executed to finance current needs. The most logical method is to divide the need into parts and to execute a series of notes that mature at intervals, thus reducing the loan as the budgeted need declines. Unfortunately, few budgets are sufficiently accurate to enable the borrower to judge exactly the flow of funds and, thus, the maturity dates that the notes should bear.

The most convenient method is that of signing notes for the desired sums to run until after the budgeted need is past, with an understanding

that the amount of the note may be reduced by partial payments in advance of maturity as funds become available.

Line of credit. Businessmen who anticipate having to finance current operations by bank loans usually ask their banks for a "line of credit" in order that they may know in advance how much they can borrow at a particular bank, without collateral, should the need arise. A bank will establish a line of credit up to the amount it feels it can safely extend to the corporation, on the basis of its knowledge of the firm's business and strength. A line of credit is an advance commitment by the banker to lend up to the indicated maximum for the agreed purposes. However, the commitment by the bank is not a contractual obligation that can be enforced. The established law is that the bank can change its opinion at any time about the unused portion of the line of credit. In practice, bankers find it unwise to change their stand unless circumstances have altered greatly. The interest rate on a line of credit loan is the rate prevailing at the time the funds are advanced.

While the line is open, the corporation must keep the bank informed of its operations and financial condition and must continue to maintain its deposit account there. Also, to keep the line open the corporation must make some use of it, for the bank cannot afford to maintain unused loan commitments indefinitely. The bank generally requires all loans made within the line of credit to be paid off within the period of a year and that the borrower remain free of debt for at least a 30-day period. At or near the end of the credit year the corporation negotiates again with the bank for a line of credit for another year. Many companies, notably finance companies (see page 323), are steady borrowers from banks on lines of credit. Total lines exceed the actual amount borrowed and they rotate their clean-ups with the various banks throughout the year.

To illustrate, a corporation might arrange with its bank in January to obtain a line of credit for $200,000 to run for one year. This means that the corporation can borrow as many times as necessary during the year as long as the loan balance due does not exceed the line of credit, that is, $200,000. The company may borrow the full amount in February, repay it in, say, 90 days, and borrow again, say $100,000 in May to be paid off in 90 days. In August it could borrow as much as it needed, up to $200,000, and have that amount paid off before the period for which the line of credit was arranged expired, and still have a 30-day period during which it would be free of debt to the bank.

Loan agreements. Relatively large corporations and banks sometimes enter into formal loan agreements. The agreement stipulates the maximum amount that can be borrowed, the interest rate at which all loans under the agreement will be made, and the requirements that the borrower must meet. The agreement binds the bank to make loans to the borrower at any time within the period of the agreement that

the borrower wants funds, provided, of course, that the borrower meets the conditions set forth in the agreement. For its commitment to lend, the bank is usually paid a specified commitment fee on any unused portion of the total credit available.

Loan agreements of this kind may provide for (1) revolving credit, (2) a term loan, or (3) a stand-by commitment.

1. Under *revolving credit,* a corporation may borrow on a short-term basis, for current needs only, up to the specified maximum at any one time outstanding, with the right to borrow, repay, and borrow again at any time during the specified period, usually from two to five years.

To illustrate, a corporation might arrange for a revolving credit of $1,000,000 for 2½ years at 2½ per cent interest. The company could then borrow as many times as circumstances required during the 2½ years as long as the total of loans outstanding at any one time did not exceed $1,000,000. All loans would be made at 2½ per cent as fixed in the agreement, regardless of market changes in interest rates. The bank, however, would require the recipient of the revolving credit to pay a small fee, about ½ of 1 per cent per annum, on the unused balance of the credit.

2. Under a *term loan* the corporation borrows immediately the entire amount of the credit for current needs or for any other specified business purpose, and agrees to repay the loan in monthly, quarterly, semi-annual, or annual installments over the specified period, usually from two to ten years. See the discussion of term loans at page 431.

3. Under a *stand-by commitment,* the corporation is given the right to obtain a term loan, on specified terms, for current needs or other purposes at any time during the specified period, usually from three to five years.

The conditions of the agreement are usually such that, at the time of the need, the corporation's credit would be good enough to obtain the loan without the agreement. The advantage sometimes gained by the contract is the predetermination of the rate of interest to be charged on the possible loan. If rates are rising there may be some gain for the borrower. Also, the commitment may avoid a shift in the loan policy of the bank. However, experience indicates that, on the whole, there is little to be gained from a commitment agreement.

Sale, discount, or pledge of notes or contracts receivable. As a means of converting receivables into cash for current needs, notes or contracts receivable may be (1) sold to or discounted with a bank, a finance company, or other lender, or (2) pledged with a bank or other lender to secure a direct loan to the business.

Sale or discount of notes or contracts receivable. Financing by means of the sale or discount of notes or contracts receivable is particularly appropriate, and even necessary, when a business is engaged

in the sale of automobiles, household appliances, and other consumer durable goods, on the installment plan. The purchaser makes a down payment and signs a contract, with a promissory note attached, to pay a certain amount each month until the balance of the purchase price, along with interest, insurance, and other charges, is fully paid. This security contract is usually a conditional sale contract or a chattel mortgage. The purchaser has no contact with the bank or sales finance institution until after the sale is made—the seller, or dealer, handles all details of the transaction. After the sale is closed, the dealer endorses the note and security instrument to the financing agency and immediately receives the selling price of the product, less the down payment made to him by the purchaser. Thus, the dealer gets cash for the sale and the finance agency gets the carrying charge to be paid by the purchaser.

Dealer arrangements. Sales finance companies and banks finance retail installment sales under several types of plans. The type chosen varies with the financial institution, the product, the locality, and the dealer.

No-recourse plan. The financing institution assumes all risk. If collection is impossible, the institution repossesses the goods and stands any loss. Under a no-recourse plan, the dealer is prone to be less selective of the credits submitted to the financing institution and, consequently, might have a high percentage of rejections of prospective purchasers.

Limited recourse plans. Both dealer and financing agency assume the risk. The dealer is required to repurchase the contract if the purchaser becomes delinquent before he makes a specified number of payments.

Full recourse plan. The dealer assumes all the risk. If the financing institution cannot collect, it assigns the contract back to the dealer, who attempts to collect the remaining installments or repossesses the property.

Repurchase of goods plan. Under a repurchase plan, if the purchaser defaults in his payments, the financing agency locates and repossesses the property at its own expense and takes it back to the dealer. The dealer buys back the property and then sells it as a used product. Thus, the financing agency and the dealer share the risk.

When a dealer repurchases a contract, as he does under limited recourse and full recourse plans, he is usually required to pay the net unpaid balance of the contract. The net unpaid balance is the gross amount less the unearned insurance premium and the unearned discount charge.

Pledge of notes or contracts. Notes or contracts receivable, when properly endorsed or assigned, may be pledged with a bank, a

finance company or other lender as collateral security for a direct loan to a business. Under an arrangement of this kind, the business will issue its own note to the lender on a collateral note form listing the receivables pledged, payable on demand or on some specified or determinable maturity date. This listing may be made on the collateral note form or in an attached schedule. The amount borrowed, as evidenced by the collateral note, may be moderately or substantially less than the unpaid balance, or the aggregate of the unpaid balances, on the receivable or receivables pledged as security. The extent of the difference depends upon the quality of the receivables, the needs of the borrower, or, in general, upon negotiation between the borrower and the lender. For similar reasons, the interest or discount rate charged by the lender may be greater or less than the financing rate being charged by the borrower on the notes or contracts pledged.

Loans secured by accounts receivable. Both large and small corporations in many different lines of business, for example, aircraft parts, boats, clothing, lumber, and printing, raise funds needed for current operations by obtaining loans secured by a pledge of accounts receivable, or by selling their accounts receivable.[5] Wholesalers, manufacturers, and dealers with a limited amount of working capital, or whose business is subject to periodic or seasonal fluctuations, especially find accounts receivable financing useful.

For a long time banks took the attitude that a sale or pledge of unsecured book accounts was the last step before bankruptcy, and that the accounts did not constitute a firm foundation for a bank loan. As the experience of finance companies (sometimes called commercial credit companies) showed accounts receivable financing to be sound from the borrower's and the lender's viewpoints, the banks came to realize that accounts receivable are prime and not "bottom of the barrel" collateral. Today this type of financing can be arranged through the company's own bank or through a finance company.

The method of financing receivables used by banks, and generally by finance companies, is carried out through a formal agreement, referred to as the *underlying agreement* or *working plan,* which is a continuing arrangement for advancing funds against open accounts. This agreement specifies what percentage of the value of the assigned accounts receivable will be available to the borrower. The percentage is usually from 75 to 80 per cent, though in some cases the margin runs from about 65 to 85 per cent. It also sets forth the rights and

[5] A loan is subject to the state usury laws; a purchase and sale is not. Whether the transaction is a sale or a loan, the accounts receivable are "assigned" to the one who advances the money to the debtor. The transaction, even if technically a sale, is essentially a loan. Therefore, in this discussion the financing is referred to as a loan secured by accounts receivable.

liabilities of the parties and the over-all conditions by which each assignment shall operate. Assignments of accounts receivable are made from time to time as the business needs funds. At such time the company prepares a schedule of the assigned accounts and, in the case of a loan, executes a demand note in the amount of the loan. The assignee (lender) usually stamps the assigned accounts in the company's accounts receivable ledger, indicating that the account has been assigned. (A few states require this book-marking to validate the assignment.) The manner in which the assigned accounts are collected depends upon whether the accounts are transferred under the notification or non-notification plan.

Notification and non-notification plans. Banks and most finance companies use the non-notification type of assignment. Under this plan the debtors of the borrower are not notified of the assignment of their debts. The borrower collects the accounts and either remits the proceeds to the lender in their original form, or deposits them in a special agency account, which is subject to withdrawal by the lender only. The borrower prefers the non-notification method because it makes for better relationships between it and its customers. The debtor dislikes being told that he is to pay his account to a third person; he suspects that the company to whom he owes the money is financially weak and unreliable; and he realizes that if his account is not paid promptly, a third person, the bank or finance company, will know about his delinquency and thus his credit standing will be jeopardized.

Under the notification type of plan, which is used by factoring concerns (see below) and some finance companies, the original invoice or bill is sent to the customer stamped with a notation "Assigned to ...." The debtor pays directly to the finance company. The purpose is to protect the finance company from collection and fraudulent appropriation by the borrower.

Security of accounts receivable loans. The accounts against which advances are made usually have a maturity of from forty-five to sixty days, though sometimes the term of credit may be ninety days or even, in exceptional cases, six months. The lender has as assurance that its loan will be repaid, first, the debt owing from the customer of the borrower; second, the general liability of the borrower; and third, in some cases, a guarantee from a third party, for example, the officers of the customer or some manufacturer who does a large business with the customer. If accounts are not paid promptly, they are usually carried from thirty to sixty days at the stipulated cost. Then, in the case of a sale, the borrower buys back the slow or unpaid accounts; in the case of a pledge, it substitutes other accounts or repays the amount loaned against the unpaid account. Out-and-out losses on accounts

receivable loans arise only when there is fraud or where both the borrower and the customer whose account was assigned fail.

Charges for accounts receivable financing. The charges vary not only from financing agency to financing agency but from customer to customer of the same agency. The agreement stipulates the charges. The loan may be made at interest, computed on the average daily outstanding balance during a specified period. Or the amount borrowed may be discounted. Or a service charge may be levied based upon the total number of accounts and the face amount of the receivables. Some finance companies have both an interest and a service charge.

Factoring of accounts receivable. In certain lines of business, factoring companies are used to convert accounts receivable into cash. A continuing agreement is made between the seller of the merchandise and the factoring company under which the factor contracts to buy all of the accounts receivable as they arise out of sales by the seller. The factor assumes all the risk and has no recourse if the accounts receivable prove uncollectible. The factor, therefore, passes upon the credit standing of the customer to whom the goods are sold. Most factors operate on a notification basis. In fact, the invoice for the goods is sent to the factor and mailed by it to the customer. The invoice shows that payment is to be made to the factoring company.

The factor is paid a fee of 1 or 2 per cent each month on the face amount of all accounts bought the previous month. This charge is for assuming the credit risk. In addition, the factor charges interest at the rate of 6 per cent per year. However, this charge is deducted from the payment for the accounts. For example, if an invoice of goods for $1,000 is sold on 60 days' credit and the seller wants cash immediately, the factor will give the seller $1,000 less 6 per cent for 60 days, or $990. The following month the fee on the $1,000 will be billed to the seller or deducted from future advances. Although factoring is an expensive method of raising funds, it eliminates the need for a credit and collection department by the seller who has his accounts factored. Also, it provides a source of working capital funds for those who might have difficulty borrowing from a bank. The factor, in other words, will advance funds under conditions that other lending agencies would not accept.

Factoring, as explained above, is an outgrowth of a method of operation under which factors sold cloth for textile mills to many small manufacturers and distributors. The factor assured the mills of payment for the sales made and often advanced money to the mills until the accounts became due. In the course of time, "selling agents" took over the selling operations of the factors and the factors became principally outright buyers of accounts receivable. Today this type

of factoring is found in such fields as leather, lumber, and petroleum products as well as textiles, and in the importation of textiles, clothing, shoes, and candy. Factors are themselves financed like other firms through the sale of securities to the public and by borrowing from commercial banks.

Assignment of funds under performance contracts. The existence of a specific construction, production, or other performance contract with a responsible individual, firm or corporation, may enable a business to obtain funds for current needs purposes. It may be able to borrow from a bank, a finance company or other lender against the assignment to the lender of funds due or to become due under the contract.

The acceptability of a performance contract as loan security may be dependent on:

1. The terms of the contract, including restrictions against assignment.
2. The financial responsibility of the party obligated to make payments under the contract.
3. The extent to which an assignable value may have been created under the contract by partial or complete performance on the part of the assignor to the date of the assignment.
4. The appraisal by the lender of the assignor's ability to complete the contract strictly in accordance with its terms.

Performance contracts are usually financed on a notification basis. Contracts with the United States Government must be eligible for assignment under the Assignment of Claims Act of 1940 and the notification procedures specified in that Act must be strictly observed.

Inventory financing methods. *Inventory financing* comprises both financing the purchase of inventories and arrangement of loans for current needs with commodities or inventory items as collateral. The financing agency may be the seller of the merchandise, a bank, a finance company, a factor, or any other lending agency.

The methods and instruments most commonly used in inventory financing are the following:

1. Bill of lading.
2. Trade acceptance.
3. Banker's acceptance.
4. Warehouse receipt.
5. Trust receipt.
6. Factor's lien.
7. Conditional sale contract, deed of trust, or chattel mortgage.

Advances against bills of lading. When a corporation wants cash immediately for a shipment of goods to a customer, it may get it by drawing on the buyer and using the bill of lading as collateral, pro-

vided the goods are readily saleable and not perishable. To see how this is done, the following terms must be understood: bill of lading, sight draft, and time draft.

A *bill of lading* is a receipt given by the railroad or other carrier to the shipper. It shows who shipped the goods and the person to whom the carrier is to deliver them. It is not only a receipt but serves also as a contract to deliver the goods and as documentary evidence of title to them. A properly endorsed negotiable ("order") bill of lading gives the holder the right to possession of the goods. It is therefore an instrument that a bank may conveniently accept as security.

A *draft,* sometimes called a bill of exchange, is an instrument drawn by one person (the drawer), ordering a second person (the drawee) to pay a definite sum of money to a third person (the payee) on sight (sight draft) or at some definite future time (time draft). The drawer and payee may be, and frequently are, the same—that is, a seller may draw upon a buyer in favor of the seller.

Advances secured by bills of lading are effected as follows: the seller arranges with the buyer to permit the seller to draw sight or time drafts against the buyer in settlement of transactions between them. After shipping the goods, the seller turns the draft and bill of lading over to its bank. The bank forwards the papers to the buyer's bank. In the case of a sight draft, the buyer's bank collects the draft from, and releases the bill of lading to, the buyer, who can then get possession of the goods. The seller is paid promptly because the draft was payable at sight. In the case of a time draft, the buyer's bank obtains the buyer's acceptance of the draft and usually releases the bill of lading to him without further security. The bank holds the draft and advances the money to the seller for the time that the draft has to run.

Financing with trade acceptances. A trade acceptance is an instrument drawn by a seller directing a buyer to pay a certain amount at a fixed future time to cover the purchase of goods from the seller by the buyer. The obligation to pay is acknowledged in writing on the face of the instrument by the buyer. The acceptance states on its face that it is drawn for a specific transaction. The seller is the drawer and also the payee. The buyer is the drawee and the acceptor. By arrangement with a supplier, a business may use such a device to finance inventory purchases. In turn, the seller can raise cash for current needs by endorsing the trade acceptance and discounting it at a bank, if the bank is satisfied with the combined financial strength of the seller and the buyer.

Steps in the use of a trade acceptance. When goods are sold with the use of a trade acceptance, these are the steps necessary to complete the transaction:

1. The seller sends a trade acceptance form with the invoice of the goods. This is signed by him as drawer and addressed to the buyer as drawee. It shows the net amount of the invoice and the date the T.A. is payable.

2. The buyer "accepts" the obligation by writing across the face of the instrument the date of his acceptance and his name, and in some cases where it is to be paid. He then returns it to the seller.

3. If the seller is not in need of funds, he holds the T.A. until a few days before it is due and then deposits it in his bank, just as he does a check. The seller's bank sends the acceptance through to the bank where it is payable, as though it were a check, and it is charged to the customer's account, like an ordinary check.[6] If the seller needs funds and does not want to wait until the T.A. is due, he discounts the acceptance at his bank or sells it in the open market through acceptance dealers.

Trade acceptance's place in credit. The place of the T.A. in credit should be carefully distinguished from that of the promissory note. The T.A. is given for a purchase and should not be used instead of a promissory note for an extension of time on a past due account.

The trade acceptance is not used extensively in this country, the chief reason being the opposition of buyers, who prefer buying on open account. Under the T.A. plan buyers must sign instruments depriving them of the opportunities for late payments that an open book account allows them. Moreover, the idea persists among many buyers that only a poor account is asked to give a trade acceptance. Therefore, some customers are offended when sellers ask them to accept a T.A.

Financing with banker's acceptances. Some corporations finance the purchase of merchandise through the use of *banker's acceptances.* By negotiation between the seller and the purchaser and between the purchaser and the purchaser's bank, a draft, with bill of lading attached, for the purchase price of the merchandise is drawn on, and accepted by, the purchaser's bank rather than on, and for acceptance by, the purchaser. For example, a manufacturer in New York, let us say, wishes to sell a merchant in Texas on 90 days' time. The manufacturer will send the bill of lading to the Texas merchant's bank with a draft on the bank. The bank will accept the draft because it has assurance that the draft will be paid at maturity. This assurance rests on the high credit standing of the Texas merchant or on the fact that the bank holds the bill of lading or some other document as collateral. The bank is liable to the drawer of the draft but it, in turn, looks to

[6] There are some states where this procedure cannot be followed. These states are named in *Credit Manual of Commercial Laws,* published annually by the National Association of Credit Men.

the merchant for repayment. When the New York manufacturer receives the banker's acceptance, it can discount it at its own bank or sell it in the open market, that is, through a discount house.

Since banker's acceptances are prime risks and have a ready market, the seller will have no difficulty in disposing of the acceptance immediately at a relatively low rate of discount.

The majority of banker's acceptances are made by banks in such cities as New York and Boston against imports of merchandise. They may be secured, however, by warehouse receipts or other documents of title, as well as by bills of lading, which may be released to the purchaser under trust receipt.

Loans secured by trust receipts. Some companies obtain the funds needed to finance the acquisition of inventory items by using the trust receipt device. Originally the trust receipt was used to finance the importation of raw materials that had to be processed or manufactured.[7] Now it is used most widely in the domestic field by dealers to finance the purchase of durable goods such as automobiles, televisions, radios, refrigerators, and the like, that are sold to consumers on the installment plan and that are easily identified by a serial number. This use of the trust receipt is also referred to as a *floor planning* arrangement.

The method of arranging a short-term loan with a trust receipt as collateral can best be explained by illustrating how it operates in the case of an automobile dealer who does not have the cash to acquire the cars from the manufacturer without financial help. The dealer applies to his bank or to a sales finance company and there arranges

[7] The following is a description of the use of the trust receipt in financing the importation of raw material:

"A person or corporation in this country desires to purchase from a merchant in a foreign country $25,000 worth of chemicals. Not having the money to pay for the goods, but expecting to sell them at a profit or to use them in manufacture, the importer goes to the bank and makes a contract whereby the bank agrees to extend to the importer the necessary credit to pay for the goods upon their arrival by accepting the draft drawn for the purchase price upon presentation of the same with the bill of lading, consular invoices, etc. The bill of lading carrying the right to the possession of the goods either passes by indorsement in blank or is made to the order of the bank giving the acceptance. When the goods arrive and the papers are presented, if everything appears in satisfactory form, the bank accepts the draft presented for the purchase price of the goods and receives the documents entitling the holder to their possession. The bank then notifies its customer, the importer, who calls at the bank for the purpose of carrying on the transaction. Up to this point it will be noted that neither title to nor possession of the goods has at any time come to the importer, the intended ultimate purchaser. It is the importer's and not the banker's business, however, to dispose of or to use the goods which are now in this country, and in order to do so, he must necessarily have possession of the same. The bank therefore delivers to him the bill of lading so that he can obtain the goods, but to protect itself takes back from its customer, the importer, what is known as a trust receipt." W. Taylor, "Trust Receipts," *Cornell Law Quarterly*, January, 1921, pages 168–169.

a credit under a trust receipt plan for whatever amount is needed to pay for the automobiles. The dealer then places the order for the automobiles and instructs the manufacturer to draw on the bank for payment and to forward the bills of lading, or other documents of title, to the bank, either in the bank's name or to order. When the automobiles arrive, they are paid for by the bank, which takes the documents of title and, thus, title to the automobiles. At this point the manufacturer's interest in the transaction is terminated.

Obviously the bank does not wish to sell the automobiles to which it now has title. That is the dealer's business. The bank is concerned with the repayment of, and the profits on, the credit it has advanced to the dealer. To accomplish the purposes of both dealer and bank, it is necessary to get the automobiles into the dealer's hands for resale. At the same time, the bank naturally wishes to retain its title as security for the money advanced. To consummate this transaction is the peculiar function of the trust receipt.[8]

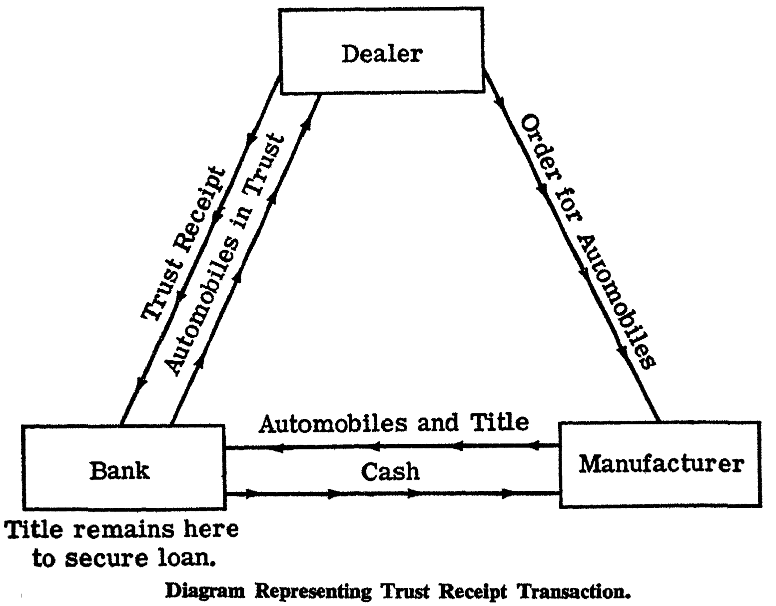

Diagram Representing Trust Receipt Transaction.

[8] Trust receipts are agreements between the bank (lender), called the "entruster," and the corporation (borrower), called the "trustee." A third party, the manufacturer, is involved, but he is not a party to the agreement.

The Uniform Trust Receipts Act, which has been adopted in more than half of the states, clarifies the rights of the financing agency's interest against the dealer's creditors, trustee in bankruptcy, assignee for creditors, and *bona fide* purchasers. To meet the opposition of secrecy surrounding the financing agency's interest, the act provides that the lender shall file with the designated state official a statement that the lender expects to finance, under trust receipt transactions, the acquisition of goods by the trustee (borrower).

A trust receipt agreement is executed by the dealer and delivered to the bank, which, in turn, delivers the documents of title to the dealer. The trust receipt recites that the dealer has received certain automobiles that are the property of the bank and that the dealer will hold them or their proceeds in trust for the bank. When an automobile is sold, the proceeds are used to repay the bank or finance company and the trust receipt for the particular car is cancelled. The diagram on page 338 represents the transaction.

If the cars are sold on the installment plan, the dealer will obtain the cash with which to repay the bank or finance company by selling the installment sales contract to either a bank or a finance company. The sale of the installment contract is described on page 324.

The trust receipt is also used to protect the lender when it becomes necessary to release goods held under a warehouse receipt or bill of lading so that the borrower can sell them.[9]

Loans secured by warehouse receipts. A corporation that wants to buy such nonperishable commodities as grain, cotton, wool, tobacco, lumber, or other inventory items that are to be stored in a warehouse, can borrow from banks or finance companies to pay for such purchases by using warehouse receipts as security for the loans.[10] Also, a corporation that owns such commodities stored in a warehouse may borrow directly from a bank by giving the warehouse receipts as collateral. The practice enables the corporation, among other things, to build up inventories at the most advantageous time; to take advantage of cash or quantity discounts; to provide capital for its business at periods when production and operating costs are at a peak and working capital is low.

It will help to understand the nature of the loan and the financing of the purchase if the warehouse receipt is explained first. A warehouse receipt is simply a receipt for goods placed in a warehouse. At one time all goods financed by warehouse receipts had to be stored in independent public warehouses. Since these were often not near the borrower's place of business, inconvenience and extra expense resulted. To avoid this result, a form of service known as "field warehousing" was developed by means of which the warehousing is done on the premises of the borrower. A warehousing company takes a lease of a part of the borrower's premises on which it displays its sign as occupant. The borrower makes written application for storage space therein and a representative of the warehousing company signs and issues warehouse receipts to cover the deposited goods and then takes custody of them. Since the agents of the warehousing company are bonded against

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[9] See page 340.

[10] The Uniform Warehouse Receipts Act, which has been adopted in all states, determines the rights and liabilities of the warehouseman, the party who deposited the goods, and the party to whom a warehouse receipt is negotiated.

"any act or acts of fraud, dishonesty, forgery, theft, larceny, embezzlement, wrongful extraction, or willful application or misappropriation or breach of trust," there is little danger of loss through collusion between the operatives of the warehousing company and the agents of the borrower.

Now let us see how a purchase is financed with warehouse receipts as security. The buyer advises his bank that he is ordering goods from the seller and arranges to have the bank pay the draft the seller will forward to the bank with the bill of lading covering the shipment. The seller ships the goods and sends the draft and bill of lading to the buyer's bank. Upon arrival of the shipment, the bank pays the draft, after first having obtained a note from the buyer covering the cost of the goods. To get the goods, the buyer must obtain the bill of lading from the bank. In exchange for the bill of lading (which represents title to the goods), the buyer gives the bank a trust receipt covering the goods. With the bill of lading, the buyer can get the goods and have them stored in a warehouse, taking the warehouseman's receipt. He turns this warehouse receipt over to the bank, which cancels the trust receipt. The warehouseman will release the goods only upon surrender of the warehouse receipt by the bank or upon proper notice from the bank ordering partial release. The bank will not give up the warehouse receipt or order a partial release of the goods unless the borrower reduces the loan in proportion to the value of the goods released, or gives the bank a trust receipt covering the goods withdrawn. When the goods covered by the trust receipt are sold, the proceeds are used to pay off the loan and the trust receipt is cancelled.

Now let us look at a typical loan on warehouse receipts where the merchandise is already "field warehoused" on the borrower's premises. The borrower, let us say, is a toy maker who is accumulating inventory for the Christmas trade and needs additional cash. He will offer the warehouse receipts to a bank as collateral for a loan. When he gets an order from a department store, he buys back one of his warehouse receipts from the bank and fills the order. Gradually, as sales are made, all of the warehouse receipts are bought back, which, in effect, is a repayment of the loan.

Factors lien. By complying with the requirements of the Factors Lien Act, in those states in which such an act has been adopted, a factor, a bank, a finance company or other lending agency is able to lend to manufacturers (and in some states, to other forms of business) against the pledge of all raw materials, goods in process, finished goods, and any and all other materials that the borrower may own in connection with the operation of its business. The lien is a continuing one and applies to the entire inventory that may be on hand at the time of the necessity of enforcement.

Procedures under factors lien. The lien agreement between the borrower and the lender must be placed on public record and usually provides that the borrower will report to the lender at frequent intervals the nature and value of the inventory in the hands of the borrower at that time. The borrower agrees that it will, upon a reduction in its inventory, make payments to the lender on its loans equal to or greater than the amount of the inventory reduction. For obvious reasons, the lending agency usually requires a liberal margin of inventory values against its advances, inspects the inventories at frequent intervals, and follows loans of this kind with exceptional care.

Liens on fixed assets. In some instances, to supplement other security, or in the absence of other acceptable security, a business may give a bank or other lender a lien on the real estate or other fixed assets of the business as collateral security to a short-term loan for working capital purposes. To secure a current loan, for example, a deed of trust or real estate mortgage may be given on a store or plant property, or a chattel mortgage or deed of trust may be given on machinery, equipment, fixtures, motor vehicles, or other capital assets of this kind used in the business. Usually, however, loans against such security are payable over a longer term although they have been obtained for current purposes.

Pledge of stocks and bonds. Stocks and bonds are the most common form of collateral for a bank loan, but are not used as extensively for commercial loans as for investment and personal loans. Today, only a small percentage of the short-term commercial loans are security loans. Bankers, with their broader understanding of commerce, find it more practical to accept documents of ownership of commodities as collateral.

Research Question

Compare the current ratio and the working capital of all corporations as shown in the latest Securities and Exchange Commission release over the past six-year period. Have companies strengthened their working capital position? How do you account for the change?

Problem

Mr. Jones finds that he can make an advantageous purchase of raw materials now (July), which he will be ready to process next January. Although he doesn't have the $50,000 cash necessary to make this purchase, his bank advises him that it will make a loan of $20,000 for 90 days at 4 per cent. On the basis of the following information, should Jones borrow the money from the bank?

Sales:	May	$100,000
	June	104,000
	July	92,000
	August	80,000
	September	106,000

Collections run 60 per cent the first month, 20 per cent the second month, and 20 per cent the third month.

On July 1 he expects to have $40,000 cash on hand.

Expenses each month:	Salaries	$10,000
	Overhead	20,000
	Rent	20,000
(long term)	Interest	1,000
Normal purchases of raw materials:	July	$46,000
	August	35,000
	September	30,000

Mr. Jones believes that if he starts the months of August and September with $7,000 cash on hand it will be sufficient. He doesn't worry about October as he believes that business will pick up sufficiently to take care of his cash needs.

CHAPTER 17

Management of Income

Meaning of management of income. Management of income, in its broadest sense, includes the management of each phase of the company's business because the minutest activity of the business usually involves income or expenditure. The subject must be narrowed down for our purposes to questions with which the financial managers are most concerned. The financial managers are distinguished here from the managers of production, selling, and record-keeping (accounting), although the latter are also responsible for the revenues from operations and the costs of obtaining them.

Financial management's major problem is to be able to present an income statement to the stockholders that reflects profitable use of the moneys they put into the business originally plus the accumulations of income that have been retained in the business. It will facilitate the discussion to have before us the income statement given at page 344.[1] The numbers before the items have been placed there for convenience in identifying the items when necessary in this discussion.

The income statement. Attention is called to the following points concerning the income statement presented, which readers who are not well versed in accounting may find helpful:

1. Net income for the year consists of net operating income of the business plus or minus any non-operating income or expenses. The results of operations are shown in items 1 to 14. Items 15 through

[1] Income statements vary in form from company to company and with the purpose for which they are prepared. The one given in the text has been selected because it makes a distinction between operating and non-operating income and expenses. Income statements presented to stockholders in annual reports rarely include the results of operations in such great detail that competitors are given an advantage. The reports furnished to directors and officers to promote financial control, on the other hand, are prepared in sufficient detail to connect given results with possible causes.

25 are the additions or subtractions of non-operating profits or losses.

2. The cost of sales, item 9, takes into account the purchases of raw materials, the difference between the opening and closing inventories, manufacturing costs including factory payroll, factory rent, real estate taxes, repairs and maintenance, light, fuel, and so on. It also includes depreciation and any other costs that management decides are a proper charge to operations.

THE ABC CORPORATION
Income Statement
Year Ended December 31, 19—

1.	Sales—less returns, allowances, and discounts		$6,418,461.04
2.	Deduct cost of goods sold:		
3.	Inventory from previous year	$1,104,438.12	
4.	Add costs incurred during the year:		
5.	Materials, supplies, services purchased, etc.	3,306,521.28	
6.	Wages, salaries, company contributions to employee benefit plans, etc.	2,651,875.76	
7.	Depreciation	65,415.39	
		$7,128,250.55	
8.	Deduct inventory carried to next year	1,253,305.25	
9.	Cost of goods sold		5,874,945.30
10.	Gross profit on sales		$ 543,515.74
11.	Deduct operating expenses:		
12.	Selling expenses	$ 172,023.13	
13.	General and administrative expenses	82,272.23	254,295.36
14.	Net operating income		$ 289,220.38
15.	Add non-operating income:		
16.	Interest on notes receivable	$ 6,000.00	
17.	Dividends on investment securities	29,581.54	35,581.54
18.	Total net operating and other income		$ 324,801.92
19.	Deduct non-operating expenses:		
20.	Miscellaneous charges		10,100.12
21.	Net operating and non-operating income		$ 314,701.80
22.	Deduct interest on notes		16,648.90
23.	Net income before income tax		$ 298,052.90
24.	Deduct income tax		113,298.14
25.	Net income		$ 184,754.76

3. Item 11, operating expenses, includes administrative salaries, salesmen's salaries, express, salesmen's traveling expenses, advertising, sales promotion, telephone, insurance, stationery, postage, professional services and other operating expenses.

4. Non-operating income, item 15, refers to income from dividends, interest on bonds, interest on notes receivable, and other items of income that do not result from operations.

5. Non-operating expenses, item 20, include miscellaneous charges against non-operating properties such as taxes, caretakers' costs, and other expenses.

6. All items that management considered income *for the year* or charges against the income *of the year* are reflected in the net income for the period. If any items were credited to or charged against surplus or earnings of a previous period, they are not reflected in the net income, but in a change in the surplus account. Similarly, any items of nonrecurring gain or loss, such as the profit or loss on the sale of fixed assets, would be shown in a change in the surplus account. Changes in surplus are often presented in a separate statement of surplus, and reflected in the surplus account in the balance sheet.

Forms of income. Ordinarily, two sources of regular income are available for large companies; and perhaps, too, these sources are of the same relative importance for small companies. They are: (1) revenue from regular operations and (2) other income.[2] In reporting income, these two sources are treated separately in order that the managers may know just what the financial condition is. In the income statement illustrated at page 344, revenue from regular operations is shown in item 1; other income is included in item 15.

We shall consider these two sources, beginning with the one that, for an operating company, is the least important, namely, other income. The most important item included in other income is income from investments.

Income from investments—temporary funds. Income may be received from two types of investments: one kind holds funds temporarily, whereas the other represents control over subsidiaries and is therefore permanent. The vicissitudes of business have taught businessmen that if their companies are to stand firmly through a business depression and to maintain regular payments of dividends, they must conserve their earnings by creating ample reserves [3] and by permitting the surplus to accumulate. Where such a conservative policy is adopted, the problem arises of investing the funds that represent savings for future contingencies.

Against maintenance of funds to meet contingencies for which reserves are created, there is always the argument that funds invested directly in earning assets yield so much more than when invested in

[2] Terminology is not uniform in the use of the words *income* and *revenue*. Some accountants use them synonymously; others differentiate between them. Generally *revenue* is applied to operating income only and *income* is regarded as a generic term embracing *revenue* as well as income from other sources. In this discussion revenue is limited to operating income.

[3] The subject of reserves will be discussed in Chapter 19.

securities of other companies that the risk involved in the contingencies should be obviated, if possible, by very careful management instead of by tying up funds. This argument leads to the next, that if the business cannot profitably use accumulating funds, it should turn them over to the stockholders as dividends, so that each may invest the funds as he sees fit. At any rate, this practice prevents the manipulation that might arise if directors invested funds in various other corporate enterprises; it likewise keeps the attention of the officers on their own business problems and off investment problems.

The determination of an investment policy requires an understanding of sound investment principles and an analytical knowledge of the securities available for purchase. The principles of investment are treated in books on that subject and cannot be discussed here.[4] The kinds of securities a corporation buys with extra cash available between seasons and with funds scheduled to be used eventually for expansion were mentioned at page 220.

Investments in subsidiary companies. Income derived from the stocks and bonds of subsidiaries must be watched carefully.[5] Whatever the income is, it must be examined at the source; the subsidiaries must be shown to be earning the income. Such questions as the following may be asked in respect to the subsidiaries: does the income flow from true earnings or does it arise from revaluations of assets or from sales of assets? before arriving at the amount of net income available for dividends, has the company made adequate allowance for the maintenance of its property? has the company followed those rules laid down in another chapter of this book, respecting dividend policies? is the company going to need cash for meeting forthcoming maturities of funded indebtedness? [6]

[4] See Badger and Guthmann, *Investment Principles and Practices,* 4th ed. (Englewood Cliffs, N. J.: Prentice-Hall, Inc., 1951). See also Graham and Dodd, *Security Analysis,* 3rd ed. (New York: McGraw-Hill Book Co., Inc., 1951); John H. Prime, *Investment Analysis,* 2nd ed. (Englewood Cliffs, N. J.: Prentice-Hall, Inc., 1952).

[5] In connection with income from investments, one should examine carefully the schedule of investments and make careful analysis of book values and present market values of the separate issues held. These values should also be checked with valuations determined by capitalizing the earnings of the subsidiaries.

[6] Although parent and subsidiary companies are separate entities, they constitute a single business organization. Therefore, it is usual to prepare a consolidated income statement, balance sheet, and surplus statement for the combined organization. In consolidated statements, all intercorporate relationships are eliminated. Thus, in a consolidated income statement the profit on intercompany transactions of subsidiaries considered in the consolidation is usually omitted. Also, income derived from the stocks and bonds of subsidiary companies would not be shown as such in the consolidated income statement. If the consolidated income statement is prepared as though the parent company had a 100 per cent ownership of the stock of subsidiary companies, when in fact less than 100 per cent of the stock of the subsidiary is owned, the statement must show the proportion of the income or loss applicable to minority interests. This item usually appears after the "net profit" or "net loss" item, although in some statements it is placed ahead of the figure showing the net profit or loss for the period.

Revenue from operations. We have already seen that attention must be given to revenues from operations in preparing budgets. They must also be studied and analyzed when management makes its financial plans for expansion of the business. The latter entails establishing long-term objectives of the business. These objectives are concerned primarily with such matters as the ultimate size of the business, the nature of the products the company will manufacture and merchandise, and the manner in which such products will be distributed and sold.

Analysis of operating revenue requires consideration of (1) the size of the revenue in relation to capital used, (2) the stability of revenue, and (3) increases in revenue in relation to operating expenses. A fourth point, the relation of revenue to cash inflow and outflow was discussed in the chapter on working capital.

Size of revenue in relation to capital used. Management studies the size of the revenue in relation to capital used to ascertain whether a greater volume of sales should be obtained for the amount of capital employed in the business. It arrives at a figure that tells it how much gross revenue has been received for each dollar of capital used in the business. The larger the gross revenue per dollar of capital employed, the better the possibility of having a net revenue sufficient to pay a fair return on the amount of funds invested in the business.

To find the ratio of operating revenue to capital used, the so-called "capital turnover ratio," the capital must be found first. For the purpose of this ratio, capital consists of all outstanding preferred and common stock, plus surplus and undivided profits, and funded debt, less intangible items in the assets such as goodwill, trade-marks, patents, copyrights, organization expense, and the like. The ratio, which is found by dividing annual operating revenue (gross sales less deductions for returns, allowances, and discounts) by the capital, shows what percentage operating revenues are of total capital. If the figure is 200 per cent, it means that for each dollar of revenue there is 50 cents of capital invested. In other words, capital has turned over twice in producing the operating revenue. Obviously, the relation of revenues to capital varies considerably with the kind of business.

Each company must study its own ratio of gross revenue to total capital over a number of years to detect the trend, and, where possible, must compare that trend with the trend of other companies.[7] The re-

[7] Information on typical ratios for a large number of different lines of manufacturing and retail businesses is given in the tables published annually by Dun & Bradstreet, Inc. Some general data are given in the quarterly reports of the Federal Trade Commission and Securities and Exchange Commission for all United States manufacturing corporations, called the "Quarterly Industrial Financial Report Series." Trade associations also prepare studies of financial and operating ratios for their members. For a study of policies, practices and techniques of trade associations in compiling ratios, see *Financial and Operating Ratio Surveys by Trade Associations*, published by American Trade Association Executives, Washington 4, D. C.

sults of this comparison are usually significant in showing whether the company is getting sufficient sales volume for the amount of capital used in the business.

Related studies may also be necessary in analyzing the adequacy of gross revenue. The company should determine whether it is gaining or losing ground in the industry by measuring the percentage which its sales volume in dollars is of the total sales in the industry from period to period.

In dealing with the problem of how to increase gross revenue, management must cope with the difficult problem of the price factor. The matter of fixing the price low enough to attract buyers but still high enough to yield the maximum aggregate return is usually left to those in charge of the marketing function—the sales department. But the marketing department is interested primarily in "making a good showing" by increasing the total revenues or sales. These aims of the sales department may defeat the purposes of the production department, which is concerned primarily with the diminution of the cost of production per unit of output. The marketing and the production departments therefore should be required to supply the financial or executive department with a schedule of estimated sales and costs, based on various scales of products that are likely to be produced and sold. The ultimate decision of price should then be left to the financial or executive department, whose interest is not in how big the gross revenues shall be or how small the operating expenses per unit of output can be made, but in how these two problems can be reconciled to the company's ultimate advantage in the form of large profits.

Advantages of stable revenues. Although there is no direct correlation between the stability of revenues and the profitability of a business over a complete business cycle, stability of revenues is one of the aims of business. We have already mentioned its importance in raising capital.[8] Other advantages of stable revenues are: (1) It expands the amount of business that can safely be done on loaned capital. This point was explained at page 174 in connection with trading on the equity. (2) It permits the enterprise to maintain its organization. (3) It enables management to plan ahead carefully and to control performance efficiently. (4) It makes ultimately for stable dividends. (5) It helps to keep prices steady. Since, on the whole, society benefits from a steady level of prices, everything possible should be done to maintain such a level.[9]

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[8] See page 183.

[9] On the other hand, it can be argued that reasonable fluctuations in the price level make for social progress. The argument is too long to be given here. It follows, in general form, the principle of the survival of the fittest. It is true, for example, that increasing prices injure those with fixed incomes—but not the alert bondholders

What makes for stability of gross revenues. Stability of gross revenues will ordinarily be the result of one or more of four elements: (1) nature of business, (2) size of business, (3) possession of elements of monopoly, and (4) good management.

Nature of the business. It is a notable fact that enterprises dealing in basic commodities and services have more stable revenues than those dealing in luxuries. Public utilities, for example, have more stable revenues than railroads, since the former minister to the public's basic needs, whereas the latter are dependent on general business conditions and on such variable conditions as those represented by the size of the crops. In a severe recession, industries supplying durable and producers' goods suffer heavier losses than industries supplying non-durable and consumers' goods.[10]

Size of business. Mere size of business has a salutary effect in keeping revenues steady, where size is a result of product diversification. Enterprises characterized by large-scale production, up to a certain point at least, have a wide margin of profit when compared with smaller concerns, and can stand temporary losses better than the small company. Also, they have the means to purchase basic commodities in advance of price increases.

Possession of elements of a monopoly. Other things being equal, a concern that enjoys some elements of monopoly will have a steadier revenue than one that is subject to the vicissitudes of a competitive regime.[11] The elements of monopoly may grow out of patents, copyrights, special franchises, location at a site that is particularly suitable for the company's business and not available to others (for example, a manufacturer of fine cut-glassware may be located where the best sand for the purpose is found), or the large cost of reproducing plants.

Good management. Since stability of revenues has so much to recommend it, good management will aim at stability for its own sake. This is not the place to point out how this aim can be carried out. One example must suffice. A fairly small concern, selling its product through the mail exclusively, found a product that it could produce

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who at such times exchange their bondholdings for stockholdings. Of course, large institutions like insurance companies and heavily endowed eleemosynary institutions cannot readily make the exchange, and annuitants have no protection against rising prices. (But see *variable annuities* at page 216.)

[10] See W. L. Crum, *Corporate Size and Earning Power* (Cambridge: Harvard University Press, 1939) for statistical proof of this statement.

[11] This statement is not necessarily to be used as the basis of the following arguments: monopolies make for steady revenues; steady revenues are good; therefore monopolies—state or otherwise—are good. The fallacy is that the steady revenue is good for the particular business, whereas the conclusion derived above assumes that whatever is good for the individual is good for the whole. A concern that has a monopoly, though it may be able to maintain a steady level of prices, may be very unprogressive.

very profitably and that could be sold in great quantities in one season of the year. It hired salesmen during that season, but found that the expenses of hiring salesmen for the rush season and then letting them go were very great. It therefore looked about for other products that could be marketed during the off seasons, and in this way not only increased its revenues, but made them more stable as a result of having a salesforce through which it might, at dull times, exert continued marketing effort.

Cost of sales. Referring to the income statement at page 344, it will be noticed that from the net sales or operating revenues is deducted the cost of sales. In this item, as has already been pointed out, are the costs of materials and supplies, labor and other manufacturing costs, and the portion of cost of buildings, machinery and equipment allocated to operations (depreciation). These costs vary considerably with the nature of the business. For example, in a meat-packing company about 75 cents of each dollar of revenue may be consumed in materials and supplies, whereas in a paper company about 35 cents may be used for this purpose. Similarly with labor costs. In operating a particular railroad, 50 cents of each dollar of operating revenue may be spent on payrolls; in a gas and electric company operating payrolls may take 18 cents. In the same way, the various items that make up manufacturing costs vary from industry to industry. But comparison of these costs in a particular company over a period of years is highly significant to management. Comparison of costs of sales with other companies in the same line of business can rarely be made because each company regards these data as strictly confidential.

Operating ratio. The ratio of operating expenses to operating revenues is known as the "operating ratio." It is one of the most significant financial statistical units. Given two concerns in the same line of business, the one with the lower operating ratio is likely to be better managed. We say *likely,* because one of the two competing concerns may seem to have excessive operating expenses, but may make up for the excess in lower fixed charges. The other concern may be energetic in its adoption of labor-saving devices; these will reduce the operating expenses but will increase the amount required for fixed charges or for maintaining a given rate of dividends. For this reason, two concerns should not be given a comparative rating on the basis of their operating ratios alone. However, the operating ratio is an important unit and should always be made the basis of careful analysis and study.

Fixed and variable expenses. Under the general classification of "expenses," sometimes called "overhead," "burden," or "loading," are included all necessary costs of running the business, exclusive of (1) costs of material that become part of the finished product, and (2) costs of labor performed directly on the product.

Expenses do not all vary in direct proportion to changes in revenue. Thus, it is a mistake to think that the operating ratio is a fixed percentage and that the operating expenses can be determined from year to year by applying the same percentage to the given revenues. If in one year the revenues are $100,000 and the operating expenses $60,000 (the operating ratio in that year will be 60 per cent), it will not follow that in the next year, if revenues are $150,000, the operating expenses will be $90,000. This is so because some expenses are *wholly variable*, some are *fixed* or *relatively invariable*, and others are *partially fixed* or *semi-variable*.

Wholly variable costs move up and down in exact or straight-line relationship to the activity of the business. They are expenses that would not exist were it not for the volume of work. For example, small tools, factory supplies, and defective product (scrap) are generally wholly variable. However, what is totally variable in one company may not be in another. The same expense may even show different characteristics of variability among different departments of the same company.

Fixed or *relatively invariable costs* are relatively unaffected by changes in the volume of business. The following description of the situation in an industrial enterprise shows the nature of fixed expenses: [12]

> This fixed expense in any plant usually consists of fixed administration salaries, office expenses, and a fixed selling expense. The selling expenses include the salaries of the sales department and the usual advertising expenses to keep the product known, but exclude the commissions paid salesmen, which naturally vary in proportion to volume and hence are not a fixed expense. It (the fixed expense) will also include a certain proportion of the indirect pay-roll of the factory, namely, that of the superintendent, the foremen who would be employed regardless of volume, the production department, a certain number of storekeepers to keep the storerooms in condition, tool-room keepers, checkers, inspectors, pensions, taxes, insurance, fire protection, a proportion of the engineering department, a proportion of the factory fuel which is needed to keep the plant on a going basis, telephone charges, water, depreciation, etc.

Partially variable or *semi-variable expenses* include costs that are neither wholly variable nor relatively fixed, but contain both elements. These costs rise and fall with corresponding changes in volume, but not in direct proportion with changes in volume; they can be reduced as volume falls, but cannot be eliminated entirely when there is no production whatever. Factory clerical expense is one example; others are advertising, communication, and power.

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[12] Vol. IV, No. 9, of the official publication of the National Association of Cost Accountants.

Simple example of importance of fixed and variable costs. A simple example will make clear the importance of recognizing degrees of variability in analyzing the costs of running the business. In the making and selling of books, the fixed costs in manufacture are (1) editorial work in preparing the manuscript for the printer, (2) setting the type, (3) proofreading, (4) correcting errors discovered while proofreading, and (5) locking the forms in the press. The variable costs are (1) press work, (2) paper, and (3) binding. Perhaps the revenues from an edition of one thousand books will just meet the costs—fixed and variable. If an edition of two thousand is run off instead of an edition of one thousand, on the second thousand all the fixed costs will be saved. Of course, if a two-thousand edition is printed, the risk is run of not selling the second thousand and of therefore losing the variable costs on that thousand. We have here but another example of risks offsetting chances of enlarged profits.

The statements made above can be reduced to more understandable form if we use a concrete though imaginary example. Let us suppose that the fixed costs of producing a book amount to $2,000, and that the variable costs, including selling expenses (leaving out overhead, however, since it would merely serve to complicate the situation unduly), are $2 a book.

If 1,000 books are printed and sold at $5 each, the result will be:

Receipts		$5,000
Fixed Costs	$2,000	
Variable Costs	2,000	4,000
Profits		$1,000

Each book sold would yield a profit of $1.

If, now, 2,000 books are printed and sold, the result will be:

Receipts		$10,000
Fixed Costs	$2,000	
Variable Costs	4,000	6,000
Profits		$4,000
Profits on last 1,000		$3,000

Each book would yield a profit of $2, but it would be fair to regard each of the first 1,000 as yielding a $1 profit and each of the last 1,000 as yielding a profit of $3. If, however, 2,000 books are printed, but only 1,000 are sold, the venture will result in a loss of $1,000; in other words, the concern must decide whether it will risk a loss of $1,000 in order to make the additional profit on the larger edition.

The breakeven point. The management of any business that shows a net loss for the period covered in the income statement would want to know what amount of sales would be needed to eliminate the loss.

When the statement shows a profit, it might want to know what amount of reduction in sales would have wiped out the profit. The point in dollars of sales at which neither loss nor gain is made is known as the *breakeven point*. The breakeven point is not an invariable figure for all time for a particular enterprise. It may change from time to time as the factors affecting it undergo change. For example, changes in price levels and in the costs of materials are two of several factors that might affect the breakeven point.

Despite the variability of the breakeven point, computing it yields information useful for guidance in making business decisions other than those mentioned in the preceding paragraph. Management may want to know the amount of sales needed to produce a certain amount of profit before taxes, or to produce a certain amount of profit before taxes if direct labor costs are reduced because of additional volume. We shall not attempt to explain here how to determine the breakeven point in the various situations for which it may be calculated.[13] We shall, however, assume that the publisher in the example at page 352 wanted to know how many books it would have to sell in order to break even, and shall show the computation.

The pertinent facts there given were that the fixed costs were $2,000 and the variable costs $2 a book. The selling price per book was $5. To solve the problem on the basis of those facts, we may assume that x equals the number of books to be sold at the breakeven point.[14] The total income will then be x multiplied by the price of each book, or $5x$

[13] For a complete explanation of how to compute the breakeven point in a number of situations, see *Corporate Treasurer's and Controller's Encyclopedia*, ed. by Lillian Doris, Chapter 9, "How to Compute and Use the Breakeven Point," by A. J. Ammon (Englewood Cliffs, N. J.: Prentice-Hall, Inc., 1958).

[14] Attention should be called to the fact that the problem usually contains another element, which turns on the principle known to the economists as the law of diminishing returns. Included in the variable costs will be the element of selling costs. These are not constant per unit. It will cost the publisher more to sell the last books of an edition than to sell the first books. For example, if a publisher prints 2,000 books, his manufacturing costs beyond the fixed costs of $2,000 may be $1 a book. While his manufacturing costs for each of the 2,000 books will remain $2, his selling costs will not be the same for each of the 2,000 books. He may be able to sell 500 books at a cost of $1 each; 500 more at $2 each; 500 more at $3 each; and 500 more at $4 each. If under these conditions a publisher sold the edition of 2,000 books, his income and outgo would be as follows:

Income:		
2,000 books @ $5		$10,000
Costs:		
Fixed manufacturing costs	$2,000	
Variable manufacturing costs @ $1 × 2,000	2,000	
Selling costs:		
500 @ $1	500	
500 @ $2	1,000	
500 @ $3	1,500	
500 @ $4	2,000	9,000
Profit		$1,000

words, there must be a charge to operating costs for the *use* of the company's assets.

Keeping the company's property up to original value. In some lines of business—those having wasting assets like timber, oil, and minerals—the operations of the concern use up the owners' assets. The assets are said to be depleted, and the process is called *depletion.*[17] But even in ordinary industrial and mercantile concerns the same thing may happen, not so quickly as in the case of the mining, oil, and timber companies and not so apparently, but for that reason all the more disastrously. Even the directors may not realize how the assets are being used up. Railroads, for example, have exhausted their assets through operations; because the funds have not been available to repair equipment, the equipment has gone on without repair till the disrepair has affected the service of the company, reduced its revenues, and brought it into the hands of a receiver. Almost any railroad receivership will reveal trouble of this kind.

Theoretically, capital is self-perpetuating. A business that uses capital does not earn profits unless the income first bears the cost of maintaining the value of the capital used. Our problem, then, is to discover what happens to impair this value and what may be done to maintain it.

Depreciation—a definition. Depreciation is not an out-of-pocket expense. It is a bookkeeping entry for arriving at reasonably correct figures for the year's net profits and taxable income. Depreciation charges a fair share of the cost of fixed assets to each year of anticipated life. The amount charged is an expense or offset against the particular year's earnings. However, it is dangerous and incorrect to assume, as most laymen do, that depreciation amounts cover a reasonably accurate charge to operations for the use of the capital assets employed in the production of the company's output, and that the reserves built up over the years will enable the company at any time to replace the exhausted assets.

Various professions have attached different meanings to the word *depreciation*. Perhaps the accountant's view is the most useful.

The Committee on Accounting Procedure of the American Institute of Certified Public Accountants has approved the following definition:

> Depreciation accounting is a system of accounting which aims to distribute the cost or other basic value of tangible capital assets over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of valuation. Depreciation for the year is the portion of the total charge under such a system that is allocated to the year. Although the allocation may properly take into account occurrences during the year, it is not intended to be a measurement of the effect of all such occurrences.

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[17] See page 415 for dividend policies of companies with wasting assets.

Depreciation charges and replacement costs. The foregoing definition and correct terminology tend to overcome the periodic attempts to correlate depreciation charges with replacement cost. Those who argue this question overlook the fact that the theory of depreciation covers only the recapture of original or basic cost. It does not provide for any difference between the original and basic cost and the cost of replacing the asset. The problem of providing for replacement cost, therefore, is not relevant in a discussion of depreciation. It seems appropriate, however, to mention that many business executives, secure behind their annual depreciation allocations, continue to overlook the fact that their profits may be seriously overstated as a result of ignoring replacement costs. This overstatement of profit could be followed by overpayment of dividends, and consequent serious impairment of the company's financial position when the time comes for replacing exhausted production facilities.

No reliable method has been developed for measuring this replacement cost. A lump sum appropriation from earned surplus is generally used and, to date, seems the most practicable method of handling the problem. Other methods involving index numbers, annual appraisal of plant values, or application of a fixed percentage to cost of sales have been attempted, but no real pattern for arriving at an accepted figure has yet been reached. Until such a pattern gains widespread acceptance, all such charges will go unrecognized by the Treasury Department as equitable charges to operations subject to deduction in computing taxable income.[18]

How much depreciation? Depreciation, as an operating expense, has the effect of reducing earnings realized in the current accounting period. The question, therefore, of how much shall be charged to depreciation is extremely important. The answer to the question is, theoretically, as much as the assets lose in value through all the causes operating to depreciate them. But in practice this answer will not do, because we cannot ascertain what those losses are. So we must make estimates. The estimates all depend more or less on the estimated life of the assets for which depreciation is being considered. Then, too, they depend on the nature of the causes of loss of value that operate during that estimated life. But, in addition, the estimates of how much should be reserved from year to year depend on questions of financial policy that will be examined in Chapter 19.

The importance of correct depreciation cannot be overemphasized. Overdepreciation, or attempting to amortize the asset cost too quickly, results in a higher product cost, which may result in losing a profitable

[18] Richard J. Hanwell, "Controlling Plant and Equipment Costs," in *Corporate Treasurer's and Controller's Encyclopedia,* ed. Lillian Doris (Englewood Cliffs, N. J.: Prentice-Hall, Inc., 1958).

market. On the other hand, underdepreciation, or insufficient amortization, can result in too low a product cost and corresponding capital depletion. Therefore, it is very important that, whenever competitive pricing is a factor, amortization of capital assets be carefully studied and periodically revised in order to reflect current values (replacement or reproduction) rather than book values.

Let us then discuss the five basic methods of computing depreciation: (1) straight-line method, (2) production method, (3) diminishing-balance method, (4) sum of the years-digits method, and (5) sinking fund method. In all of these methods except the third, actual original cost may be reduced by a declared salvage value and then depreciated.

Straight-line method. The simplest method is to charge the same amount each year over the estimated life of the asset and in this way liquidate completely the original cost. Thus, an asset costing $6,000 with an estimated life of ten years would be depreciated at $600 a year. If the residual value were declared to be $600, the amount to be depreciated would be $5,400, which spread over ten years would result in a depreciation charge of $540 a year. The basic assumption in the straight-line method is that an asset depreciates at a constant amount over an estimated life period. Although this assumption is purely theoretical, alternatives may lead to complicated accounting procedures. The principal theoretical objection to this straight-line method is that it distorts costs when productivity is maintained at an uneven rate.

Production method. This method consists in allocating depreciation either by hours of operations or units produced. The method recognizes that a machine wears out according to the amount of use given it.

The "hours of operation" method is used when production is best measured by operating time. Thus, if a machine cost $10,500, has a scrap value of $500, an operating life of 40,000 working hours, and is used 10,000 hours in a particular year, the amount of depreciation to be charged against the machine for that year will be $2,500.

The "unit of production" method is used when it is easy to measure the number of units the asset is capable of producing. Thus, if the life of the machine mentioned above were 40,000 units of production, the amount of depreciation charged against the machine if it produced 10,000 units during the year would be $2,500.

Diminishing value method. This method applies a fixed percentage of depreciation to the net value of the asset at the end of each fiscal period. For example, an asset with an original cost of $10,000 might be depreciated on the diminishing-balance method at a 20 per cent rate. As a result, the depreciation charges by years would then be $2,000 in the first year, $1,600 in the second year, $1,280 in the third

year, $1,024 in the fourth year, and so on, so that, in slightly more than 10 years, the net value would equal $1,000 if that were the estimated residual value. In this method a residual value must always be set, since theoretically a true zero balance can never be reached. The chief value of this method is that it assigns greatest depreciation to the early years of the asset when maximum loss of resale value normally occurs.

Sum of the years-digits method. Under this method, the annual depreciation deduction is computed by applying a changing fraction to the cost of the property reduced by the estimated salvage value. In the fraction used for any year, the numerator is the number of remaining years of the estimated useful life of the property, and the denominator is the sum of the numbers representing the years of the life of the property. For example, an asset with an original cost, less salvage value, of $15,000 that has a useful life of 5 years would be treated in the following manner:

Year	*Remaining Years*	*Fraction*	*Amount of Depreciation*
1958	5	5/15	$5,000
1959	4	4/15	4,000
1960	3	3/15	3,000
1961	2	2/15	2,000
1962	1	1/15	1,000
	15*		$15,000

* Denominator—this can be obtained by the use of a simple formula:
If S = sum of the digits, and
N = number of years of useful life, then

$$S = N\left(\frac{N+1}{2}\right)$$

Thus, substituting in the formula, for an asset with 5 years of estimated useful life, we get: $S = 5\left(\frac{5+1}{2}\right) = 5 \times 3 = 15$

The chief value of this method is that it assigns greatest depreciation to the earlier years of the asset's life, when the greatest decrease in value is likely to occur.

Sinking fund method. This method consists in setting aside a fixed sum annually for a given period of years for investment at a fixed rate of interest, so that the fixed sum plus all interest earned will equal, at the end of the stated time, the original cost or depreciable amount of the asset. Therefore, the depreciation charge against the asset each year will equal the fixed payment plus interest earned on the fund that year, and the reserve for depreciation will always equal the value of the fund. The complexity of accounting in this method has restricted its use in almost all fields, except the public utility field where it is generally used to satisfy legal requirements. Its only obvious advantage is to guarantee the replacement of funds originally expended

for an asset. Its disadvantages include the fact that the depreciation charges are higher in the later years when repairs and maintenance costs are also high, thus tending to distort profits in those years.

Relation of depreciation to taxes. Government regulation of depreciation is an exceedingly important consideration for management. The Federal income tax law, as it should, permits a deduction for what it terms "exhaustion, wear and tear (including a reasonable allowance for obsolescence)" of property used in business or in the production of income. Since the taxpayer must be in a position to substantiate the deduction, care must be taken to keep the records required by the statute. The matter is also important because if the property is sold, the depreciation previously allowed (or allowable) is a factor in computing the taxable gain or deductible loss.

Treasury regulations do not discriminate directly against any particular method of computing depreciation. All five methods outlined in this chapter have been accepted; and, generally speaking, any method that is customary in a particular industry will be accepted.

The 1958 tax law contains a provision for faster depreciation in that it permits, in the year of acquisition, an additional write-off of up to 20 per cent of the first $10,000 paid for new or used operating equipment or other tangible property (excluding buildings) having a useful life of six years or more, and which was purchased after December 31, 1957. This provision was designed to help small businesses, but it can be utilized by any business, large or small. In computing the new initial allowance, salvage need not be considered. No provision for using the initial allowance has been made in any of the preceding examples, because it is available only in the year the property is acquired.

Present maintenance in keeping up the value of assets. Management's problem in keeping the company's assets up to their original value does not end with making the proper charge to depreciation. It must also see that the assets are taken care of. A well-oiled automobile will not deteriorate and lose its efficiency as quickly as one that gets no care. Of course, this idea can be carried too far. If the care costs more than a new asset, we may permit the asset to wear out quickly and may replace it when it is worn out. We have been accustomed to following the latter practice in this country, where wages for repairs are high and machine-made replacements relatively cheap; whereas in Europe, where labor has been cheap, the practice has been to give assets great care. This form of offsetting depreciation means the expenditure of present funds and, as has already been indicated, is called "present maintenance." Present maintenance does not obviate the necessity for allocating, each year, a portion of the original cost of the assets to operations through a depreciation charge.

Fixed charges. There remain to be considered in the management of income the elements of fixed charges and taxes.

It will be noticed in the income statement given at page 344 that the fixed charges appear as a deduction after the net operating and nonoperating income has been determined. The importance of fixed charges was discussed in connection with bonded indebtedness and capital structure.[19] We also pointed out the advantage to the company of having a high rating for its outstanding bonds.[20] How many times fixed charges have been earned is always important in rating bonds; it is also important to management. In some cases, as we saw, a certain relationship must be maintained between the fixed charges and the amount of net income available to meet them before additional bonds may be issued under an indenture.[21]

In managing income, the responsible officers must be certain that the cash is available with which to meet interest payments and other fixed charges when they fall due. In the railroad field, for example, lease rental is an important fixed charge. We saw how, through the operation of a budgetary system and through reports of cash position, management watches its current position to be sure that it can meet its fixed charges.[22] If the fixed charges are heavy and earnings are unstable, it may be advisable for management to set up a working capital reserve. The nature of such a reserve will be treated in Chapter 19.

Taxes. Taxes represent either a regular periodic charge on the revenues, or an occasional and incidental charge. The latter class includes organization taxes on newly-formed subsidiaries, and inheritance taxes on the transfer through death of the interests of the owners of unincorporated businesses or of the shares of corporations and Massachusetts trusts, as well as taxes on the transfer of shares.[23]

The principal periodic taxes are the income, franchise or license, and unemployment insurance taxes. Care must be taken to see that taxes are not incurred in localities where business income does not warrant the expense.[24]

Eliminating state taxes by engaging in interstate commerce only. The managers of a business should study very carefully the law of

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19 See page 177.
20 See page 176.
21 See page 120.
22 See pages 305 *et seq.*
23 These subjects have already been discussed. See pages 30 *et seq.* and 91 *et seq.*
24 State income and franchise taxes are defined and described at length, in so far as they are peculiar to corporations, in the Prentice-Hall *State and Local Taxes* service. The unemployment insurance taxes are treated in the Prentice-Hall *Social Security Taxes* service.

interstate commerce as it affects taxability of business operations within states other than the state in which the principal office is located.

The problem may be stated thus: A corporation desires to do business in most of the states of the Union. What can it do to minimize state franchise taxes? The answer is, undertake operations in such a form as to bring them under the United States or local state Supreme Court rulings establishing certain practices as acts in interstate commerce. Since, under the Constitution, Congress has control over interstate commerce, the states cannot, through taxation, place any burden on such operations, for by so doing they would trespass on the Federal domain.[25] What acts are and what acts are not included in interstate commerce? A company cannot "do business" *inside* a state without subjecting itself to franchise taxes. But it may take orders from the state and send its goods *into* the state without paying taxes for the privilege. Thus, a mail order business ordinarily does not subject the corporation to taxes in states to which letters and circulars are sent and from which orders through the mail are received. Nor does a corporation lose its status as one engaged in interstate commerce by selling through salesmen whose orders are sent to the home state, even though the salesmen use samples; but if the salesmen sell goods they carry, they will be doing business inside the state on behalf of the corporation. And it would seem that the fact that after the order is accepted the goods are shipped to the salesmen to be delivered to the customer, does not constitute *intra*state commerce.[26]

Moreover, merely keeping an office in the state for the sole purpose of conducting interstate commerce does not constitute doing business in the state, though it comes pretty close to the line. Care must be taken not to go farther than merely maintaining an office from which salesmen can go or to which customers can come to give orders to be sent to the home state.[27] Sending goods to a warehouse in a state, from which warehouse goods can be sent to fill orders taken in that state, constitutes intrastate business and subjects the corporation to taxes. Installation of goods purchased, which by its nature cannot be accomplished by local workmen, is an act of interstate commerce. But if the corporation installs machinery, such as a soda fountain, that

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[25] See pages 36–38.

[26] See Robbins v. Shelby County Taxing District, (1886) 120 U.S. 489; Pembleton v. Illinois, etc. Ass'n, (1919) 289 Ill. 99, 124 N.E. 355; Loeb v. Star & Herald Co., (1919) 187 N.Y. App. Div. 175, 175 N.Y.S. 412; Dunn-Salmon Co. v. Edwards, (1915) 68 Pa. Super. Ct. 340; International Text Book Co. v. Pigg, (1909) 217 U.S. 91, 30 S. Ct. 481; and International Text Book Co. v. Tone, (1917) 220 N. Y. 313, 115 N.E. 914. See "Doing Interstate Business," Prentice-Hall Corporation Service, pages 7000 *et seq.*

[27] Cheney Bros. Co. v. Massachusetts, (1918) 246 U.S. 147, 38 S. Ct. 295.

could be installed by local workmen, it will be held to be engaged in business inside the state and will have to pay the tax regularly imposed on foreign corporations.[28]

Although the above statements still represent the law, the tax immunity of interstate corporations is, partly at least, in process of disintegration. The trend has been to place greater emphasis on the realistic effect of the tax rather than on purely formal connotations. If the corporation has maintained regular, substantial property, employees, facilities and the like within the taxing state, partaking of the benefits and opportunities the state affords—and particularly if the corporation has availed itself of the local markets at any point in the interstate operations—the more recent court expressions have indicated that the corporation should pay its "fair share" of the tax burden based on an apportioned or apportionable part of the income or other tax base.

The Federal income tax. Federal income taxes are paid in general on net earnings, that is, on gross income less expenses. Although no loyal citizen will desire to evade just taxes, he must for his own protection minimize taxes in order to compete on a fair basis with other concerns in the same line of business.

The avoidance of unnecessary tax liability is an important subject but, unfortunately, space does not permit us to do more than scratch the surface. In the first place, the law itself gives the taxpayer numerous elections; for example, the right to value inventories one way or another, the right to take a deduction for a reasonable addition to a bad debt reserve, the right to spread a profit over a period of years in the case of certain installment sales, and the right of affiliated corporations to file separate or consolidated returns. Quite frequently the manner in which a transaction is handled determines the tax liability; for example, whether an old machine is traded in or sold, whether investments are switched at the right time to produce a deductible loss. An important principle is to make transactions unambiguous and thus avoid costly argument with tax authorities. For example, repairs are deductible, but the cost of improvements is not because such items must be capitalized. If practicable, repairs and improvements should not be undertaken at the same time, but, if they are, a detailed record should be kept of the cost of repairs. Abandoning outmoded equipment results in a deductible loss, but a sale, when practicable, avoids any argument as to the year of the loss.

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28 As to the amount of the tax, and for other information about the tax laws of each state, see the Prentice-Hall *State and Local Taxes* service. The propositions stated in the text are supported by Browning v. City of Waycross, (1914) 233 U.S. 16, 34 S. Ct. 578, and General Ry. Signal Co. v. Commonwealth of Va., ex rel. State Corp. Com., (1918) 246 U.S. 500, 38 S. Ct. 360.

Net losses or deficits. If a business continues to operate during hard times, it should keep its accounts just as carefully as it does at any other time, in order to be able to take full advantage of the loss deductions allowed by law. Under the Internal Revenue Code, a net *operating* loss may be carried back three years (returns will be amended and refunds claimed) and the amount not used as a carry-back may be carried forward five years.[29] For example, a net operating loss for 1958, until exhausted, may be applied against income for 1955, 1956, 1957, 1959, 1960, 1961, 1962, and 1963 in the order named. Thus, a net *operating* loss for 1958 would be applied first against 1955 income (usually by way of claim for refund). The unexhausted portion would then be applied against 1956, then 1957 income, and if any part of the loss still remained unused, against 1959–1963 income.

Salaries and the income tax. We have already explained that a corporation may deduct reasonable salaries paid to its officers but may not deduct dividends paid to its stockholders, and have pointed out the importance of this rule to the small and moderate-sized closely-owned corporations.[30] It is worth repeating here that in a close corporation, where the stockholders are also the managers, income taxes may be minimized by paying the stockholder-managers the maximum salary possible under the income tax regulations.[31]

Employee pension and profit-sharing plans and the income tax. The income tax law permits a corporation that has created a pension, profit-sharing, or stock bonus plan, or trust [32] that meets the qualification requirements of Sec. 401 of the Internal Revenue Code to deduct, within certain limitations, amounts contributed to the plan or trust in the year the amounts are contributed. The employee benefits tax-wise in that the employer's contributions to the plan or trust do not constitute taxable income to him until distributed or made available to him. At that time, generally, the employee is in a lower tax bracket. Furthermore, a lump-sum payment when the employee retires, or when employment is terminated, is taxable as capital gain. This tax-saving feature is particularly valuable to the executives and key men of a corporation who may participate in the plan or trust. (See page 33 for other employee plans that offer tax benefits to the executive-stockholder.)

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29 Internal Revenue Code, Sec. 172. Exceptions, additions, and limitations intended to preclude a deduction when there is no economic loss greatly complicate the law.

30 See page 31.

31 One word of caution should be added. Distributions of profits under the guise of salaries are not deductible, and this is especially true if the payments are in proportion to stockholdings.

32 A trust is used to administer some types of pension plans, but not others. A profit-sharing or stock bonus plan must be administered through a trust to be qualified.

The qualification requirements are of a general and specific nature. The general requirements of a plan are (1) it must be for the exclusive benefit of employees, or their beneficiaries; (2) its sole purpose must be to offer employees, or their beneficiaries either a share of the profits of the business or an income after retirement; (3) it must be permanent; (4) it must be in writing; (5) the contributions or benefits provided under the plan must not discriminate in favor of employees who are officers, shareholders, supervisory or highly paid employees; (6) it must be communicated to the employees; (7) where a trust is used, it must be impossible under the trust instrument for any of the trust corpus or income at any time to be used other than for the exclusive benefit of the employees or their beneficiaries; (8) certain information must be filed annually with the Commissioner of Internal Revenue.

The specific requirements touch almost all of the features of the plant. For example, to qualify, a pension plan must meet certain requirements concerning employees permitted to participate in the plan, retirement age, benefit payments, and so on.

It is usually financial management's responsibility to propose the type of plan that will (1) meet the needs of the business and its employees, (2) afford the maximum advantages in improved personnel relations, (3) be actuarially sound and not require greater contributions by the employer than it can safely undertake; and (4) fulfill all the requirements of the law to enable the corporation to take the allowable deduction of its contributions in arriving at its income tax.

Research Question

Compare the earnings per share of Monsanto Chemical, U. S. Steel, Borden, and Consolidated Edison for the past ten years. Which would you say had stable earnings?

Problem

Diagram the depreciation reserve each year, by the straight-line method, of a machine whose original cost is $84,000, life is 15 years, and "turn-in" value is $9,000.

CHAPTER 18

Financial Statement Analysis

*by Richard E. Ball, Ph.D.**

Introduction. Financial statements such as the balance sheet, the profit and loss statement, and the source and application of funds statement, are constructed to present useful over-all summaries of the financial data accumulated by a firm. A proper analysis of these statements provides valuable insight into the financial condition and operations of a business. Such analysis is important, therefore, to all who have an interest in the functioning of a particular business. Among those who are most directly concerned with the various tools of analysis, who use them most and are most keenly aware of their need and importance, are our business executives, bankers, investors, and credit managers.

Undoubtedly the most interested are the business managers, especially the executives who are responsible for finances and financial management. The complexities of modern-day business management, with its large-scale production and distribution particularly, have made it impossible for the business executive to keep in close personal contact with each of the activities of the business. He must rely increasingly on accounting controls and summaries; thus the importance to him of financial statements. By means of financial statements, supplemented by other detailed operating and statistical data, the business executive can (1) measure the effectiveness of his own policies and decisions, (2) determine the advisability of adopting new policies and procedures, and (3) document to owners the results of his managerial efforts.

Bankers and the credit men of individual business houses have come to rely heavily on financial statements for the information they need in establishing credit risks. Credit appraisal today is no longer a

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matter of personal relations. Financial statements, and more specifically the individual creditor's interpretation of financial statements, is now the principal determinant in credit decisions.

Stockholders and bondholders have likewise a major interest in the financial statements of business organizations. They share a common concern for the solvency, earning power, and future prospects of the business firm in which they have made capital commitments. Financial statement analysis is their means of re-enforcing judgments or of forming new judgments regarding the advisability of maintaining the capital investments they have undertaken.

Financial Statements and Preparation

Principal types of financial statements. While the general term "financial statements" may include a variety of data, there are three major and interdependent forms of financial statements that are vital to financial analysis and financial management. These are (1) the Balance Sheet, (2) the Profit and Loss Statement, (3) the Source and Application of Funds Statement.

Balance sheet. The balance sheet shows the nature and amounts of all assets owned, the nature and amounts of all liabilities, and the type and amount of residual investment of the owners in the business. In its very complex exhibits, the balance sheet reveals the source of funds used in the business and delineates areas where these funds have been applied. The data presented on a balance sheet are taken as of a single date and must be appraised in this light. This financial statement is frequently titled Statement of Financial Position.

Profit and loss statement. The profit and loss statement is a statement evidencing, over a limited and specified period of time, the source and amounts of the income of a business firm for the specific period, the nature and amounts of all costs and expenses of operation for this period, and the net earning or loss for the period. This financial statement is frequently titled Statement of Income.

Source and application of funds statement. As its name implies, the source and application of funds statement portrays the inflow and outgo of funds. It shows the *causes* of net changes that occur in working capital between two balance-sheet dates. In this way the variation in the flow of funds and their sources is measurable and usable for financial and operating analysis. The statement implements both the single balance sheet and single profit and loss statement to produce a dynamic comparison between a minimum of two dates of the business history.

Individual and consolidated statements. In analyzing the financial statements of a corporation, it is important to determine whether the statements are those of a single corporation or whether they represent

a consolidation of the data of the parent corporation with the data of the subsidiary or subsidiaries. When a corporation owns a controlling interest in the voting stock of one or more corporations, a typical practice is to provide an over-all view of the financial condition and operating results of the group or system by using consolidated balance sheets and profit and loss statements. Consolidated statements are helpful for analytical purposes, but create a responsibility for recognizing the legal separateness of the corporations involved.

The principles of appraisal which apply to individual corporate statements apply, with minor refinements, to the consolidated statements as well.

Financial statements and types of business organization. The conventions of accounting have standardized financial statements to some degree. Nevertheless, financial statements do vary somewhat from one type of business organization to another. For purposes of analysis, it is important to know the variations associated with each particular form of business. The following operative business types are discussed briefly: (1) retailers, (2) wholesalers, (3) manufacturers, (4) service organizations, and (5) finance companies.

Retailers. Retailers buy and sell finished goods. As a consequence, their inventories are generally quite heavy. They have, ordinarily, a large volume of credit sales and, therefore, receivables will make up a proportionately high percentage of their resources. The exceptions, of course, are the retail houses which sell exclusively for cash. Finally, the retailer must display his merchandise expansively and in an attractive setting. It follows, then, that he will have a considerable investment in fixed assets and equipment and a relatively expensive physical location.

Wholesalers. Since wholesalers are middlemen in the distributive process, their receivables generally run high and consist, typically, of fairly large individual accounts from numerous retail concerns. Their inventories, though diversified, will bulk large in total. Their fixed assets are proportionately small and they can utilize less expensive locations and less costly equipment and furnishings.

Manufacturers. Manufacturers operate in the most complicated of all business processes, the range of activity and burden on resources being optimum in comparison with other types. As a class, manufacturers are expected to be larger, more strongly capitalized organizations than either retailers or wholesalers, with opportunities for more efficient financial management. As a type, manufacturing firms have heavy investment in fixed assets and equipment. Judging their capital requirements often poses a difficult problem to the analyst.

Service organizations. Generalizations about service organizations are difficult because of the diversity of specialized personal and pro-

fessional services represented. Nevertheless, some generalization is possible and may provide clues for financial analysis. Ordinarily, receivables do not bulk large in organizations of this type. And, generally speaking, there are no inventories, at least not in the sense of products for sale.

Finance companies. The resources of finance companies are overwhelmingly in well-diversified accounts receivable. Fixed asset requirements are generally nominal. There is, typically, the use of borrowed capital in heavy proportion to ownership capital. Studies of the loss record, and of delinquencies of receivables, are very pertinent in appraising the financial statements of firms of this type.

Place of the Business Firm in the Business Cycle

Business cycle defined. "Business cycle" is the term commonly used to describe the fluctuations in the levels of business activity which are characteristic of our free-enterprise economy. Much progress has been made in the past few decades in determining the characteristics of business cycles. Thus, today, government and business forces can act to offset, at least partially, the effects of sharp contractions and expansions. Nevertheless, fluctuations in business activity continue and must be given their due weight in any analysis of financial statements.

Importance in analytical framework. For example, when a business manager analyzes financial statements, he hopes to emerge with some idea, if not a firm prediction, of how his firm will do in the future. But financial statements are essentially historical records. While they are useful in estimating the present financial condition of the business, and in setting up guideposts for future policy, they do not shape events. Thus, in his analysis of financial statements, the business manager must be sensitive to the historical and trending pattern of general and industry-wide business events. The interrelationship of financial statements with the surrounding business climatic conditions of the firm and its industry group is much stronger than most writings have indicated. The likely influence of business trends outside of the organization must be carefully weighed in determining the probable trends of assets, liabilities, and capital as shown on the financial statements. The balance sheet, the profit and loss statement, and the source and application of funds statement must be appraised against the phase of the business cycle that prevailed at the time or period under observation. Further, the general trends and business conditions within the particular industry or business group must be considered, as they may not coincide with the over-all conditions of the economic system.

The Natural-Business-Year Argument

Natural business year defined. Authorities in the accounting and financial professions have long recommended that an enterprise close

its books on a fiscal year corresponding to its natural seasonal fluctuations. This concept is embodied in the term "the natural business year." As defined by the National Business Year Council, "The Natural Business Year of an enterprise is the period of twelve consecutive months which ends when the business activities of the enterprise have reached the lowest point in their annual cycle." This low point may be recognized when receivables, inventories, and liabilities are at or near their minimum points and when the cash position is most liquid.

Advantages of natural-business-year analysis. The general endorsement of the natural-business-year idea by accounting and financial groups rests on a significant number of advantages which are noted below.

1. From the viewpoint of balance sheet appraisal, the business firm has its liabilities at low point and thus presents the maximum picture of solvency and liquidity.
2. The various financial statements should be more complete and and reliable, since at the expiration of the natural business year incomplete business transactions and major items such as inventories and receivables should be at a minimum.
3. Analytical ratios, comparative analysis, and other vital statistical data should represent a more realistic and accurate picture of operating and financial conditions during the natural business year.

Importance of natural business year to analysis. The ability of a business to liquidate its inventories and receivables systematically and with a satisfactory profit is a reliable indication of the intrinsic soundness of its operating activities. If the firm offers evidence of its financial condition at seasonal peaks only, or at some arbitrary interim, the validity of the data for either management or outsiders is diluted. At such times, a significant portion of the assets are in the form of receivables and inventories. The ability of the firm to liquidate these assets—to turn them into cash—remains in question. Preparing the financial statements at the low point in the trading cycle, when the firm is in its most liquid position, gets around this difficulty and provides financial statements which are susceptible to sound and objective analysis.

Characteritics of Financial Statements

Balance Sheet

Objectives of balance sheet analysis. As previously discussed, a balance sheet is a static statement of the financial condition of a business organization as of a particular instant, a given date. The balance sheet thus allows one (1) to appraise the ability of the company, at the time of the balance sheet, to meet its obligations, and (2) to judge the probability of its continued ability to meet all its financial obliga-

tions. Before proceeding to the actual divisions of items on the typical balance sheet, the recognition that the balance sheet contributes importantly to managerial as well as creditor decisions must be stressed. Despite the tensions inherent in a static picture of a going business organization, the student must recognize that a means of judging a company's ability to meet its present obligations and the probability of its continued ability to meet them is a significant contribution to analysis. Nevertheless, no single financial statement satisfies the requirements of composite appraisal of the total financial and operating data of a modern business organization.

Review of balance sheet statements over a period of time is a significant contribution to trend analysis of the operating results of the enterprise, since the balance sheet does record, with considerable clarity, the net profits and losses that have resulted from past operations.

Basic divisions of the balance sheet. The mechanical arrangement of items on the balance sheet is subject to some variation within the conventions observed by accounting and management practice. For analytical purposes, it is convenient to use the following basic classification.

Assets	*Liabilities*
Current Assets	Current Liabilities
Fixed Assets	Non-Current Liabilities
Intangible Assets	*Net Worth*
Other Assets	1. Proprietorship Capital
Deferred Charges	or
	2. Partnership Capital
	or
	3. Corporate Capital
	(a) Capital Stock
	(b) Surplus

Exhibit I on page 371 illustrates a typical balance sheet.

Current assets. Current assets, in the typical concern, are the working assets of the business. They consist of cash and related assets that turn into cash in the normal short-run operations of the business. Ordinarily, the complete cycle (cash, related assets, back to cash) requires no more than a year. In some cases it may take longer than a year. Whatever the time period, it is far more useful to classify an asset as a current asset on the basis of its use, as reflected in the aforementioned cycle, than on some arbitrary time period. Normally, an analyst includes the following assets under this classification:

1. Cash on Hand and in Banks.
2. Accounts Receivable Trade Only.
3. Notes Receivable.

EXHIBIT I

THE MICHIGAN CORPORATION

BALANCE SHEET AS OF DECEMBER 31, 19..

ASSETS

Current		
1. Cash		$ 550,000.
2. U. S. Treasury Short-Term Obligations		250,000.
3. Accounts Receivable—net		775,000.
4. Inventories (lower of cost/market)		
(a) Finished Goods	$650,000.	
(b) Raw Material, Goods in Process, Supplies	300,000.	950,000.
Total Current		$2,525,000.
Fixed		
1. Land, Bldg., Machinery and Equipment—net		875,000.
Miscellaneous Investments and Other Assets		225,000.
Deferred Charges		75,000.
Total Assets		$3,700,000.

LIABILITIES

Current	
1. Accounts Payable	$ 675,000.
2. Notes Payable (Bank)	100,000.
3. Accrued Federal Income Taxes	325,000.
4. Accrued Payrolls and Other Expenses	50,000.
Total Current	$1,150,000.
Non-Current	
1. 4% First Mortgage Bonds due November 1, 1971	350,000.
Net Worth	
1. Capital Stock (100,000 shares, $10 Par Value)	1,000,000.
2. Earned Surplus	1,200,000.
Total Liabilities and Net Worth	$3,700,000.

4. Inventory.
5. U. S. Government Securities.

Cash (on hand and in banks). Cash is the most liquid asset grouping, consisting of currency, commercial bank checking accounts, and unrestricted savings accounts.

Accounts receivable. Accounts receivable should represent receivables arising out of normal business operations. Therefore, only bona fide current trade accounts receivable should be included in this classification. In all analytical procedures, only the net figure (receivables after provision for prospective bad debts) is used.

Notes receivable. In some industries it is customary to document by notes all business obligations arising from the sale of goods. Where this

is not typical, the asset may be evidence of less than current payment of trade accounts.

Inventories. In general, a maximum breakdown of the inventory asset will include finished goods, work in process and raw materials used in the ordinary course of business operations. Inventories are reported on balance sheets in a variety of ways, depending upon internal accounting systems; generalization is not easy. The selection of an inventory valuation method is of major importance because of the effect on both the balance sheet and income statement values. Conservatism, and consistency of use, are dictated.

U. S. Government securities. Surplus investments of cash in the riskless U. S. Government securities represent a current asset that is almost instantly available for introduction to the working capital of the business. Productive of income and of minimum risk, these securities represent extreme liquidity, apart from the circulating capital of the business firm.

Fixed assets. Fixed assets are those tangible resources which are used in the normal operations of a business, are typically not readily convertible into cash, and are primarily intended for revenue production. The most important classification of fixed assets includes the following:

1. Land.
2. Buildings.
3. Machinery and Plant Equipment.
4. Furniture and Fixtures.

Intangible assets. Intangible assets are those assets whose real value is dependent upon the earning power of the business. Valuation of these various intangible assets is a point of controversy among accountants, lawyers, and management, and places a burden on the statement analyst that is not easy to alleviate. Intangible assets may include the following:

1. Patents, trademarks, franchises.
2. Leaseholds and leasehold improvements.
3. Copyrights, formulas, licenses.
4. Goodwill.

Other assets. "Other assets" is a broad classification that usually absorbs assets not capable of exact grouping elsewhere in the balance sheet. Essentially other assets are those that are not utilized directly in the working pattern of the business, but represent tangible value. They must be considered in analyzing the over-all resources available to the business firm. These assets may include:

1. Investments in subsidiary, associated, or affiliated companies.
2. Non-trade receivables.
3. Cash value of insurance policies.

4. Funds earmarked for property expansion, bond and stock retirements, pension and contingent liability payments.

Deferred charges. Deferred charges are non-recurring costs that do not arise out of current operations. They represent charges to future operating periods that have arisen out of such items as prepaid interest and prepaid insurance. For analytical purposes, these items are heavily discounted because their valuation in liquidation or for appraisal of effect on operations is quite difficult.

Current liabilities. Ordinarily, current liabilities represent obligations of the business that are payable on demand or are expected to be payable within a year of the balance sheet date. If a liability is to be paid, in whole or in part, from current funds, it is generally regarded as a current liability. Classification of current liabilities usually includes the following:

1. Trade accounts payable.
2. Notes payable.
3. Deposits (deposits made by officers and employees or cash advances on orders by customers).
4. Dividends payable.
5. Accrued liabilities such as taxes, wages, and salaries, interest, and rental obligations.
6. Installments on long-term debt due within the year.
7. Contingency reserves.
8. Unearned income and deferred credits.

Non-current liabilities. By definition, non-current liabilities represent obligations of a business that come due beyond a year from the balance sheet date. The danger in appraising this group of liabilities is that the analyst may tend to assume that the non-current liabilities are of only minimum interest to the current operating practices of the firm. Because of the probability that non-current liabilities may be composed of considerable complex funded or fixed debt secured by claims against operating assets, this classification of liabilities should be given closer review than is usually given it by other than trade creditor groups. Some categories of non-current liabilities are:

1. Mortgage notes payable.
2. Bonds payable.
3. Term loans.
4. Long-term liability reserves.

Net worth. *Proprietorship net worth.* In the simplest form of business, that of the individual enterpriser or proprietor, the individual's ownership in his business is simply his capital account. While the balance sheet of the enterpriser is able to document the invested capital quite simply, it may not be able to show his true net worth inasmuch as this form of business must respect the non-business assets and lia-

bilities of the proprietor. The analysis of enterprise balance sheets needs to establish resources or liabilities which are not documented in the financial statements themselves.

Partnership net worth. In the balance sheet of a partnership, the total equity of the several partners in the resources of the firm is indicated by the net worth section. Generally, the capital funds of each partner are separated for analytical purposes. The outside assets and liabilities of the various partners are not included in the business balance sheet, although this may be important to the solvency and existence of the partnership. As in the case of the proprietorship, it may be necessary to go beyond the partnership statements to derive the real net worth of the partnership as an operating organization.

Corporate net worth. Because of the complexity and diversity in use of the corporate form of organization it is possible to have considerable variation in the format of the balance sheet summation of the net assets, or net worth, of the corporation. Despite this, the following outline is a useful guide to analysis of the items that represent the major portion of the net worth area of the balance sheet:

1. Preferred Stock.
2. Common Stock.
3. Surplus.
   (a) Capital Surplus.
   (b) Earned Surplus.
4. Reserves, which are earmarked parts of the Surplus account.

Since a prime reason for the analysis of the balance sheet is to determine the company's ability to meet its obligations, it is necessary to compute net worth as realistically as possible within the accounting and business framework available to the business. While the sum of the above items adds up to Corporate Net Worth, analysis of individual asset categories may be necessary to determine the real worth of certain questionable assets, i.e., Intangible and Deferred Charges. Adjustments in the Net Worth figure may be necessary, therefore, in any analysis of financial statements. Tangible net worth is the proper analytical yardstick for appraisal of the balance sheet.

The Profit and Loss Statement

The profit and loss statement, variously called the income statement or revenue statement, is essentially a report of business operations covering a specific accounting period. The accounting period is generally a year, either on a calendar- or fiscal-year basis.[1] Despite con-

[1] Fiscal-year reporting tends to be correlated with the natural business year discussed previously, but it is defined only as a period ending on a date other than December 31.

siderable variety in the basic format and arrangement of financial items in the profit and loss statement, a complete and valuable statement for analytical purposes should express the following:

A. Sources of Income of the major business operations for the period.
B. Major business operating expenses.
C. Operating Profit and Loss from business operations only during the period.
D. Federal Income Taxes.
E. Net Profit or Loss giving effect to all other Income and Expense items for the period.

A sample statement is shown as Exhibit II.

EXHIBIT II
THE MICHIGAN CORPORATION
STATEMENT OF PROFIT AND LOSS
FOR THE YEAR ENDED DECEMBER 31, 19..

Net Sales		$5,600,000.
Cost of Goods Sold	$3,400,000.	
Depreciation	150,000.	
Taxes, other than Federal Taxes on Income	85,000.	
Selling, General and Administrative Expenses	675,000.	
Total Operating Expenses		4,310,000.
Operating Profit		$1,290,000.
Other Income, net after deductions		25,000.
		$1,315,000.
Interest on Funded Debt and Bank Loans		20,000.
Net Income before Federal Taxes		$1,295,000.
Provision for Federal Taxes on Income		675,000.
Net Income for the Year		$ 620,000.

Profit and loss statement analytical sections. To produce a clear picture of a business firm's activities during the period reviewed, the profit and loss statement should be composed of vital data categories such as the following:

I. *Sales or Operating Revenue Category:*
The gross revenue from regular source or sources should be shown and itemized as much as possible to indicate clearly the operating income sources.

II. *Cost of Goods Sold Category:*
Because of variation among business types, such as mercantile compared with manufacturing firms, detail may be considerable or minor. Essentially, the basic costs of goods manufactured and sold or available for sale during the period, operating expenses excepted, are itemized in this category.

III. *The Operating Expenses Category:*
This classification should include all expenses incurred in the buying, selling, and administrative functions of a business firm. Because of the difficulty in distinguishing among various expenses and attempting to catalogue them precisely, profit and loss statements often have subdivisions in this section such as:

(a) Selling Expenses.
(b) General and Administrative Expenses.

The opportunities for variations in the selection of data for this category are broad. Therefore, a statement of reporting policy is desirable if the analyst is to interpret properly the operating results.

IV. *Other Income and Other Expense Category:*
The responsibility for the receipt and disbursement of funds of a business is typically that of a financial department. In this respect, the income and expense of this functional department are items closely related to the other regular operating functions of the business.

A. *Other Income* may include such items as interest income, purchase discounts, dividend income, rental income, and miscellaneous non-operating income.
B. *Other Expense* may include sales discounts, financial expenses, and a variety of miscellaneous non-operating expense items.

V. *Net Profit for the Period* (Corporation only):
This is the residual net earning power of the business. Since the Federal Income Tax is not a variable which management can control, the profits of a corporation for a given period are determined before Income Taxes. Then the Income Taxes are deducted and the net result is shown as the final net profit for the period. This final earnings figure for the corporate form of business is usually carried directly to the Surplus account on the balance sheet coinciding with the date of the profit and loss statement.

Proprietorship variations. The format of the profit and loss statement of a proprietorship varies from that of a corporation in at least two major areas.

1. No management salary expenses are allowed.
2. Federal Income Taxes are not computed on the profit and loss statement of the proprietorship since the form of organization is not taxed as a separate entity.

Thus the net profit of the proprietorship is considered as part of the proprietor's personal tax return, and for analytical purposes must always be considered as the profit before personal income taxes.

Partnership variations. The profit and loss statement of a partnership is very similar to the proprietorship statement. No provision is noted for partner salaries, for example, and Federal Income Taxes are borne by the various partners personally instead of being deducted from partnership earnings. The net profit or loss on the operations of the partnership is determined in the Profit and Loss Statement. This is then distributed to the respective capital accounts of the partners in conformity to the partnership agreement. In all other respects, the profit and loss statement of a partnership could coincide with that of a corporation.

Basic Analytical Ratios

Ratios as an aid to analysis. Up to this point, the discussion has emphasized the objectives of statement analysis and the main areas and

variations in the several statements that are important to financial analysis. The relationships of important items in these statements, when correctly chosen and placed in proper perspective, become useful guides in determining the solvency, the adequacy of earning power, and the relative efficiency of the management operations of a given firm. As an aid to analysis, some of these relationships are expressed as ratios and others as percentages.

The determination of useful relationships as opposed to relationships that have dubious value is one of the major problems of statement analysis. The computation of ratios or percentages for their own sake can hinder rather than aid the analyst. Only ratios that (1) produce significant relationships between related items or groupings of items and (2) have pertinence to the particular statement under observation should be computed. To this end, six fundamental ratios, derived from the two major financial statements, are of major importance in statement analysis. These fundamental ratios are:

1. The Current Ratio.
2. The Debt to Net Worth Ratio.
3. Sales to Receivables Ratio.
4. Sales to Inventory Ratio.
5. Net Profits to Net Worth Ratio.
6. The Operating Ratio.

Computation and use of fundamental ratios. *The current ratio.* Current ratio is a quantitative ratio, expressing the relation of current assets to current liabilities. It is important primarily to the current creditors of the business, since it measures the firm's ability to meet its current obligations. It is computed by dividing the current liabilities into the current assets. Using Exhibit I of this chapter (page 371), we can determine the current ratio to be 2.2 to 1 ($2,525,000 ÷ $1,150,000). Simply interpreted, this means that for every dollar of debt that is current, this business has $2.20 to meet that obligation. Under stress of business conditions then, this corporation's current assets could shrink slightly more than 50 per cent before current creditors would suffer and the solvency of the corporation be threatened.

In using this ratio for analysis, certain reservations must be kept in mind. First of all, the current ratio demonstrates only the quantity coverage of current assets against current liabilities. It gives no indication of the quality of these current assets and liabilities. Furthermore, there is the difficulty of determining what is an appropriate current ratio for a particular business at a particular time. The application of an arbitrary yardstick, say 2.2 to 1 as in our example, may be a good gage in one case but not in another. To properly evaluate the current ratio of a concern the analyst must have recourse to the typical ratios

of similar concerns, to industry characteristics, to seasonal, and even cyclical, factors. Used independently, without relationship to other analytical ratios, the current ratio's effectiveness is impaired.

The debt to net worth ratio. The ratio of debt to net worth measures the relationship of the creditor's capital to the owner's capital or total net worth. In the analysis of this ratio, it is most conservative to include all debt, current and non-current. Referring again to Exhibit I, computation of this ratio is accomplished by dividing total debt of $1,500,000 by tangible net worth of $2,200,000; the result is a ratio of .68 to 1. Essentially this is interpreted as 68 cents of creditor capital for every dollar of owner capital.

With some few exceptions, notably banks, consumer finance companies, and public utility industries, owners should have a greater investment in the business than the totals advanced by creditors. Because of the shrinkage of asset values during business recessions and because of the need, also, to determine the quality as well as the quantity of assets, it is necessary to go beyond this ratio to satisfy the problem of adequate owner capital protection against the claims of creditors. Despite this limitation, it is a vital ratio both for creditors and management. It gives each an insight into the financial policy of the business as measured by a single, residual ratio.

The sales to receivables ratio. The ratio of sales to receivables expresses relationships between a balance sheet figure and an income statement item. It indicates the relationships of net sales for the period, an income statement item, to the uncollected sales on hand (net accounts receivable) as of the balance sheet date. Referring to Exhibits I and II, the Net Sales figure of $5,600,000 is divided by Net Receivables of $775,000, producing a ratio of 7.4. This relationship can be refined further to show the number of days of uncollected sales represented by the receivables. Net sales of $5,600,000 are divided by 360 to arrive at a daily sales total of $15,555. Daily sales are then divided into the receivables total of $775,000. The answer, 49, represents the number of days of uncollected sales reflected in the receivables total. If the selling terms are 60 days net, this ratio indicates a satisfactory situation, but it would be an inadequate relationship if the terms of sales were shorter.

Some qualitative appraisal of the receivables is necessary for optimum use of this ratio. And the comparison of this ratio with the ratio of other firms in the same industry or with firms having similar selling policies is essential. It is only through such comparisons that the firm's own ratio as a measure of solvency and the effectiveness of management can be properly evaluated.

The sales to inventory ratio. Typically, a rather close relationship exists between a firm's inventory and net sales. Sales arise out of prior-

owned inventory, and the amount of working capital invested in inventory to produce a given sales volume is of great significance in determining managerial efficiency. Referring again to Exhibits I and II, we divide Net Sales of $5,600,000 by Total Inventories of $950,000 to get a ratio of 5.9, which indicates that, at the balance sheet date, this corporation had approximately two months' (12 ÷ 5.9) supply of total inventories on hand.

Under usual circumstances, an increasing sales to inventory ratio is generally looked upon by analysts as a favorable expression of efficient and progressive management. A declining sales to inventory ratio tends to point to a less liquid condition of the company and is symptomatic of future working capital tensions. These tensions would in all probability become evident in the ratios discussed earlier.

Before concluding, it should be noted that Net Sales figures include profit mark-ups. Inventory figures do not. Strictly speaking, the ratio would be more accurate if Cost of Goods Sold were used in place of Net Sales. But it is difficult in all instances to acquire Cost of Goods Sold figures from published statements. The important point after all is consistency of use; and since the use of Net Sales produces greater opportunity for industry and firm comparisons, this usage is the more popular one.

Net profits to net worth ratio. The net profits to net worth ratio is a fundamental calculation because it demonstrates rather effectively the efficiency of management in producing net earnings on the capital invested in the enterprise. It is particularly useful in appraising the variations in earnings over a period of time. And, finally, it is a help to management in determining the advisability of capital additions.

Using Exhibits I and II, we can compute this ratio quickly by dividing the Net Income of $620,000 by the Total Net Worth of $2,200,000, producing a percentage of Net Income to Net Worth of 28.1 per cent. In other words, for every dollar of ownership capital, the Michigan Corporation was able to earn 28.1 cents over the course of the year.

The potential usefulness of this ratio is considerable. Nevertheless, it may tend to give illusory results if used independently of other basic ratios. The company's valuation of assets and the managerial policy of depreciation and charges for losses must be weighed. They are factors since they affect net worth, which will in turn affect the ratio. Their influence, as well as the influence of the over-all policy of the enterprise, should be considered to give stature to the basic ratio.

The operating ratio. The net operating ratio has been called the "efficiency ratio" as well as the operating ratio. It refers to the relationship of Total Operating Expenses (Cost of Goods Sold and Selling, General and Administrative Expenses) to Net Sales. It is computed by dividing

these total expenses by the Net Sales figure, producing a percentage answer rather than a strict ratio. In our Exhibit II, we can calculate the operating ratio of this corporation by dividing the Total Operating Expenses of $4,310,000 by Net Sales of $5,600,000 giving a figure of approximately 77 per cent. This indicates that the management of the Michigan Corporation spent 77 cents for every dollar of net sales revenue.

In theory a stable or declining operating ratio is an indication of satisfactory management. However, the extreme use of this ratio, without relationship to other useful indicators, is a sign of hasty and immature statement analysis. In interpreting the operating ratio, considerable significance must be given to the possibility of variations in expenses from period to period and from company to company, as well as from industry to industry. The operating ratio is used best when compared with the company's own operating ratios for previous periods and then with the operating ratios for similar companies in the industry. Despite its limitations, the operating ratio retains major use and is helpful in conducting a rounded study of managerial results.

Analysis of Comparative Statement

Problems of individual financial statement analysis. To build up a useful pattern of financial statement analysis, it is necessary to go beyond the use of single balance sheets and single statements of profit and loss, because of the defects of single statement analysis. These defects include the following:

1. A single balance sheet, and also a single profit and loss statement, may not portray a usual or typical condition or experience of the organization.
2. A single profit and loss statement does not provide a comparison with previous periods of operating activity.
3. A single balance sheet does not demonstrate whether the financial condition of the organization is superior or inferior to that recorded at previous statement dates.
4. The trend of the company's earning power and/or its financial condition can only be charted by comparative analysis of statements. A minimum of two statements is required for analytical purposes.

The fundamental aim of financial statement analysis is to forecast the probable financial condition and earnings record of a particular business. The most reasonable method of estimating these results is by analyzing the past trends of the business as reflected in its published financial statements. Such analysis should go back over a sufficient period of years and be geared to the type of company and industry under observation. An analysis of comparative statements is necessary.

Philosophy of internal comparison. By definition, internal comparison is the comparison of the ratios and financial statements of a single business organization. The business organization is its own yardstick. The purpose is to record the business expansion, or contraction, resources and/or earning power over a period of time. The techniques employed allow for a continuity of data that is vital to successful projections of the company's solvency and earning power.

Major Methods of Internal Comparison

Three major techniques are useful in highlighting the comparative data of the business. These are commonly called:

1. Increase-Decrease Method.
2. Trend Percentage Method.
3. Source and Application of Funds Statement Method.

Increase-decrease method. This is a simple quantitative analysis using at least two statements to point up the net changes in the various items. It is particularly useful for a quick focus on absolute changes. It may be amplified to show proportionate changes so that a further analytical framework may be constructed. Exhibit III shows a method of calculating increases and decreases in the absolute data of balance sheets in terms of both dollar amounts and percentages.

An appraisal of Exhibit III allows an analyst to ascertain quickly the net changes in all balance sheet accounts. It is particularly useful in constructing the Source and Application of Funds Statement, a further refinement of statement analysis.

The Increase-Decrease technique can be used to compare the profit and loss statements of a company as well. With this method, the variations in the individual items in the profit and loss statements are brought into bold relief. Such comparison either allows quick visualization of the quantitative changes in the operating record of the organization or provides a means to further relative comparisons of the individual items with the operating experiences of other firms in the same industry, or in other industries.

Trend percentage method. One of the better clues to a company's financial condition and operating characteristics is derived through an appraisal of the trend conditions of selected data. By use of this pattern one can project data relative to solvency and earning, thus implementing the historical comparative analysis.

It is fallacious to speak of a single trend factor without recognizing that certain data of an organization are likely not to reflect the over-all movement of financial data. A direct year-to-year comparison of the changes within each item or account, with a base year chosen as a starting point, will help bring the trend of each account into sharp

Exhibit III

THE OKEMOS CORPORATION

Comparative balance sheets
December 31, 19.. and 19..
(In Thousands)

	A		B	C
	December 31 *19..*	*19..*	*Amount of. Increase Decrease **	*Per Cent of: Increase Decrease **
ASSETS				
Current:				
Cash	60	75	15	25
Accounts Receivable	125	110	15 *	12 *
Inventories	135	140	5	3.7
Other Current	10	18	8	80
Total Current Assets	330	343	13	3.9
Fixed:				
Buildings and Equipment—Net	315	345	30	9.5
Other Fixed Assets	35	30	5 *	14.3 *
Total Fixed Assets	350	375	25	7.1
Other Assets:	10	17	7	70
Total Assets	690	735	45	6.5
LIABILITIES AND NET WORTH				
Current:				
Accounts Payable	85	110	25	29.4
Notes Payable	60	40	20 *	33.3
Other Current	30	35	5	16.7
Total Current Liabilities	175	185	10	5.7
Non-Current:				
Bonds Payable	125	110	15 *	12 *
Total Non-Current Liabilities	125	110	15 *	12 *
Net Worth:				
Capital Stock—Common	300	300	-0-	-0-
Earned Surplus	90	140	50	55.6
Total Net Worth	390	440	50	55.6
Total Liabilities and Net Worth	690	735	45	6.5

focus. The base-year approach will help, also, in relating the changes of a single item or account to all other items and accounts in the firm's financial picture. Exhibit IV is a typical pattern for exposing the trend of certain selected items that are vital in appraising comparative change. Using a certain year as base year, and giving each data item for that year the worth of 100 per cent, successive values can be easily derived and compared with the base of 100 per cent. For example, Total Current Assets of $450,000 of the Eastwood Corporation at the end of the base year are stated as 100 per cent: dividing $450,000 into the Total Current Assets of $475,000 as of the end of the next year, gives a percentage of 106. In a similar manner, all the other percentages are computed by dividing the figures for the base year into the figures for the same data account in the subsequent years.

A cursory examination of Exhibit IV to determine the trends can provide several useful analytical judgments.

EXHIBIT IV

THE EASTWOOD CORPORATION

SELECTED ACCOUNTS AT AND FOR THE YEARS
ENDED DECEMBER 31, 19.. THROUGH DECEMBER 31, 19..
(In Thousands)
Base Year (100%)

		Base Year	*2nd Year*	*3rd Year*	*4th Year*	*5th Year*
Total Current Assets	$	450	475	535	560	585
	%	100	106	119	124	130
Total Fixed Assets	$	225	245	270	295	315
	%	100	109	120	131	140
Total Current Liabilities	$	210	231	265	280	315
	%	100	110	126	133	150
Total Net Worth	$	385	410	440	465	505
	%	100	106	114	121	131
Net Sales	$	1,450	1,575	1,650	1,785	1,925
	%	100	109	114	123	133
Gross Operating Profit	$	175	225	240	285	305
	%	100	129	137	163	173
Net Income	$	25	38	47	63	77
	%	100	152	188	252	308

(a) There is a clear-cut general upward trend in all items, although at a different rate as, for example, between the increase in Total Current Assets (30 per cent) and Total Current Liabilities (50 per cent), in the five-year period.

(b) While Net Sales during the five-year period increased only 33 per cent, Gross Operating Profit increased 73 per cent; but more significantly, Net Income increased 208 per cent. With the limited data in this Exhibit it is not possible to explain fully the reasons for the changes in these several items. Neverthelss, the bold relief shown by a comparison of the individual trend figures is more helpful than a mere quantitative use of changes in the items.

(c) Despite the favorable trend of both Sales and Net Income, Total Current Liabilities increased at a faster rate than Total Current Assets, actually reducing the solvency of this corporation in the fifth year as compared with the base year.

Weaknesses of the trend percentage method. 1. The trend technique does not identify the relationships of statement items to each other. It does show whether there has been an improvement or decline in the relationship of items, but it fails to identify the exact relationships.

2. The trend percentage method does not throw light on the quality of assets. Since it is identified with quantitative figures only, it cannot enlighten the analyst in this important analytical procedure.

3. Misleading information can result from this procedure if the base figure is either abnormally large or small, or is an atypical year or item. The use of a depressed year or years for the base data year would produce distortion, as would the use of an unusually successful year. This method demands a careful choice of a representative base year for an optimum presentation of useful data. It consequently places a burden on the analyst at all times to challenge the validity and utility of all percentages resulting from the analysis.

Despite these drawbacks, the trend percentage method is uniquely useful in presenting trends in bold outline. It is definitely useful in making a comparison of the trends of the individual data items and groups of items important to the solvency or earning power of the business organization under analysis.

Source and application of funds statement method. In recent years there has been increased interest in the internal flow of funds of a business organization. The increased interest gives recognition to the fact that business activity is essentially a dynamic process in which each business event interlocks with previous activity.

In the financial sphere, a characteristic of the going business concern is the continuous flow of cash into non-cash assets which, in turn, are converted back into cash. The balance sheet, for all its merits, is an essentially static presentation. It does not reflect the dynamic processes of financial activity. The picture of the business most vital for managerial financial analysis is one that identifies and measures the flow of funds within the business. Since the motivation of a profit-making enter-

prise is to generate more cash funds than the business originally provided, the manner of conversion of non-cash assets into cash is the dynamic indicator of both managerial competence and the financial status of the business. The nature of the changes in assets and liabilities, the quantity involved, and the speed of the flow of funds through the business are most useful data in refining judgments concerning the financial rating of any going concern.

The Source and Application of Funds Statement, known also as the "Where Got-Where Gone" statement, is used to portray the flow of funds in a business. It does so in a concise and definitive manner so that analytical judgments can be made easily. The net changes in individual asset and liability accounts, as these emerge from a comparison of two balance sheet dates, are documented and focused in the Source and Application of Funds Statement. Whatever the interval between the balance sheet dates chosen for observation, the primary purpose of measuring the flow of funds is achieved. However, the length of the interval can be a qualitative factor for several reasons. The objective of the flow of funds analysis is to determine how well management uses the resources available to it to maximize its profits. This objective is imperfectly realized if the period of time under consideration is not a typical one for the business. For example, if the period is too long, the variations exposed will be too broad to lend themselves to precise interpretation.

By referring to Exhibit III, which shows comparative balance sheets of the Okemos Corporation as of December 31, 19. . and 19. ., with the quantitative change of Assets and Liabilities between these two balance sheet dates, it is possible to construct a simplified quantitative statement, which focuses on the generalized flow of funds and uses of funds among the accounts of this fictitious corporation. This statement is shown as Exhibit V.

To construct this type of quantitative statement of fund flow measurement, it is necessary to classify the major types of changes as *Sources of Funds*, or *Uses of Funds*.

I. *Sources of Funds* are essentially documented by:
   1. Decreases in Assets, representing conversion into cash by liquidation.
   2. Increases in Liabilities, representing an external source of funds by borrowing.
   3. Increases in Net Worth, representing retained business earnings or increased capital investment by the owners.

II. In a similar fashion, the *Uses of Funds* are essentially documented by:

EXHIBIT V

THE OKEMOS CORPORATION

SOURCE AND APPLICATION OF
FUNDS STATEMENT FROM 12/31/.. TO 12/31/..
(In Thousands)

Sources	
Accounts Receivable	15
Other Fixed Assets	5
Accounts Payable	25
Other Current Liabilities	5
Earned Surplus	50
	100
Application	
Cash	15
Inventories	5
Other Current Assets	8
Other Assets	7
Buildings and Equipment—Net	30
Notes Payable	20
Bonds Payable	15
	100

1. Increases in Assets, representing increased investment of cash in these items.
2. Decreases in Liabilities, representing a commitment of funds to decrease borrowing.
3. Decreases in Net Worth, representing losses from business operations or withdrawal of capital by the owners of the business.

Using the above classification, it is relatively simple to construct a statement, represented by Exhibit V, which spotlights the nature and quantity of changes of assets and liabilities as they were affected by the flow of funds during the 12-month period under observation.

Appraisal. In analyzing Exhibit V, one can recognize quickly that the major source of funds for the Okemos Corporation was provided by retained earnings as measured by the increase of $50,000 in the Earned Surplus account. The use of borrowed funds as evidenced by the increase of $30,000 in Accounts Payable and Other Current Liabilities is quite modest against retained earnings, and is a minority (30%) of the total Sources of Funds for this period. A further conservative note is demonstrated by the reduction of the investment needed in Accounts Receivable. This is a healthy condition in view of the amount of retained earnings which result from the operating earnings of this corporation.

A quick review of the Application of Funds further confirms the conservative and adequate managerial philosophy of this firm. Reduction of debt of $35,000 as noted by the reduction in Notes Payable and Bonds Payable accounts adds stature to the financial appraisal of this corporation at the same time that there is a modest increase in Inventories and Cash and Other Current Assets. The major claim of funds is, of course, the Buildings and Equipment Account, where an expansion of $30,000 is indicated during the year under review. It is important to recognize that this is accomplished while at the same time there is a reduction of debt by $35,000, the effect being to strengthen the earning resources of this firm while improving its financial solvency and credit stature.

The major outlines of this statement give us, then, a profile of managerial operating and financial results that adds qualitative meaning to quantitative measurements. They implement the static balance sheets to offer a more dynamic view of the flow of funds through the business as the business moves from one period of operations to another.

Research Question

What were the current ratios and net sales to inventory ratios for the last five years in the automobile parts and accessories industry?

Problem

Prepare a Source and Application of Funds Statement from the comparative statements of financial position shown on page 286.

CHAPTER 19

Surplus and Reserve Policies

Questions involved in management of surplus. Upon the directors rests the obligation of managing the surplus of the corporation with the object of providing a fair return to stockholders on their investment and sufficient resources to allow for steady normal growth of the company. The stockholders get a return on their investment through the receipt of dividends. Before deciding upon dividend action, the directors must consider the following factors, which constitute the basis for managing surplus:

1. What is the corporation's surplus?
2. What amount should be set aside out of earnings and surplus for specific purposes other than dividend payments?
3. What sources of surplus are available for dividends?
4. What are the legal rules concerning the payment of dividends?

These questions will be discussed in this chapter. In the following chapter we shall present and discuss the questions that arise in connection with the payment of dividends.

What is surplus? Surplus is an excess of assets over liabilities. If we examine the assets of a company, appraise them and list them, according to American practice, on the left-hand side of the paper—and then list all the liabilities, including the capital stock, on the right-hand side—we shall ordinarily find that the assets exceed the liabilities. Therefore, to make the balance sheet live up to its name—to make it balance—we write an item under all the liabilities sufficient to bring about the balance, and we call that item surplus. The reader will understand, then, that the expression "paying dividends out of surplus" is not strictly true. Dividends are actually paid out of cash (that is, wherever it is the usual cash dividend) and the amount that can be distributed

from the assets as dividends to the stockholders is measured by the earned surplus.[1]

A word or two should be said about the true nature of surplus. When reduced to a finality, the assets side of a balance sheet describes the property of a company, and the liabilities side explains what disposition should or could be made of that property. Let us take a simple example.

Assets		*Liabilities*	
Land and Buildings	$150,000	Capital Stock	$150,000
Machinery	25,000	Accounts and Notes Payable	75,000
Inventories	35,000	Surplus	75,000
Accounts Receivable	40,000		
Cash	50,000		$300,000
	$300,000		

Here the property amounts to $300,000. Of this (turning to the liabilities) $75,000 belongs to the creditors and should, as it falls due, be paid to them; $150,000 represents original investment of the stockholders and should be used for the purposes for which it was contributed, namely: (1) to earn profits, and (2) to be conserved in order that it may be turned back to the stockholders if the company dissolves. The $75,000 in the surplus represents accumulated operating profits that have not been distributed to the stockholders. It may include extraneous profits, such as those derived from the sale of fixed assets or of investment securities. It may also include "paid-in surplus," which we shall describe later. Although it is within the discretion of the directors to declare dividends out of surplus, it would be a mistake to conclude that the surplus represents accumulated profits that the stockholders may expect to have distributed to them as dividends. In most businesses all of the profits are not distributed; hence surplus accumulates. Often this accumulated surplus represents earnings permanently reinvested in the business, or plowed back, and is reflected in the assets regularly employed in the business. Sometimes the surplus and capital stock items are placed close together in the balance sheet because they represent the owners' equity in the corporate property.

Corporate deficits. If a company has not made a profit but has lost ground, the assets side of the balance sheet will be smaller in amount than the liabilities side, and hence, to make the balance sheet balance, something will have to be added to the assets side. This item we may call "deficit," or "corporate deficit," or "loss," or, as the accountants

[1] It is hardly necessary to inform the reader that in practice balance sheets are not compiled in the way we have indicated, but for purposes of *financial* analysis they may be regarded as having been constructed in just that way. For the sake of simplicity, too, we omitted to mention reserves; these we shall take up later.

call it, "profit and loss." Where such an expression as this last phrase is used, the reader of the balance sheet, if inexperienced, must bear in mind that it gives rise to a somewhat paradoxical situation; if it is found on the assets side, it represents loss; if, as is sometimes the case in accounting statements, it is used on the liabilities side instead of what we have defined as surplus, then it is the measure of profits.

Sources of surplus. Surplus may be subdivided into (1) earned surplus, (2) paid-in surplus, and (3) unrealized appreciation of assets.

1. *Earned surplus* (more properly called *retained earnings*) arises from earnings that management has retained and accumulated. These earnings include income from operations as well as from certain extraneous transactions, such as the sale of fixed assets or investments.

2. *Paid-in surplus* (a term to be used in preference to *capital* surplus) includes the three items discussed below.

(a) Surplus resulting from transactions in the company's own stock. These transactions include issuance of par value stock at a premium, issuance of no-par stock at amounts in excess of stated value, reissuance of treasury stock at an amount in excess of what the corporation paid for it, forfeited payments made upon subscribed stock, and reductions in capital stock made through redemption at a figure less than the amount originally received for the stock.

On the sale of stock for cash in excess of the par value of the stock only the amount of the par value is considered capital. The excess represents surplus paid in or contributed by the stockholders. In the case of no-par stock, under certain statutes in some states, a part of the consideration received from the sale of the stock may be set aside by the directors as paid-in surplus. Similarly, in states that require a stated value to be assigned to each share of no-par stock, the portion of the consideration in excess of the stated value may be designated as paid-in surplus.

Another stock transaction that results in the creation of paid-in surplus is the issuance of stock for property that has a greater value than the stock given in payment therefor. Thus, if assets worth $50,000 are acquired for stock having a par value of $40,000, paid-in surplus of $10,000 is created.

(b) Surplus resulting from stockholder contributions, including both donations and assessments.

(c) Surplus resulting from contributions by outsiders. Donations of a plant site by a city to induce a corporation to locate there is an example.

3. There is no agreement in the accounting and financial fields as to where in surplus the item of unrealized increases in the valuation of assets belongs. Some financial reports still show this as part of

"capital surplus," but the accepted practice is to set up a separate division of surplus called *unrealized appreciation of assets.*[2]

Methods of eliminating a deficit. The student may question whether it is possible for the corporation, through the procedures just described, to build up a capital surplus that will actually eliminate a deficit. The answer is that it can. In the following explanation of how a deficit may be eliminated, the student will recognize that the last two methods mentioned have already been described as ways of establishing a surplus.

Under the law, as we shall see later, a company cannot pay a dividend if, at the time of the proposed distribution, the company's balance sheet reveals a deficit. We may now suppose that its balance sheet has shown a deficit for some time and that a turn of events brings to the company large current profits, but not enough to extinguish the deficit. Must the stockholders wait or can they get at these profits? For example, a balance sheet appears at the beginning of a year as follows:

Assets		*Liabilities*	
Land	$100,000	Capital Stock	$250,000
Buildings	50,000	Accounts and Notes Payable	50,000
Inventories	50,000	Reserves	25,000
Accounts Receivable	25,000		$325,000
Cash	50,000		
Deficit	50,000		
	$325,000		

The company earns $40,000 during the year. What can it do in order to pay dividends?

1. Reserves may prove to be too liberal and some of these may be converted into surplus, wiping out part of the deficit. This is discussed further at page 396.

2. An appraisal of all the property may be made and it may be found that some of the property has been carried on the books at less than its value. Thus, in the above example, the land may now be worth $150,000; if that value were brought into the balance sheet, the deficit would disappear.

3. The corporation may ask the stockholders to consent to a reduction of the capital stock under the terms of the statute. If a reduction of $50,000 in capital stock is accomplished, again the deficit of $50,-000 will disappear.

For the above practices to be effective in eliminating a deficit and creating a surplus, the action taken by the directors must be free from fraud; the directors must act honestly and in good faith. Furthermore,

[2] Accounting Terminology Bulletin No. 1 (Review and Resumé) §§ 65–70; Committee on Terminology, American Institute of Certified Public Accountants, 1953.

Assets such as patents, copyrights, patterns, publishers' plates, and so forth, should not be carried at large values by a concern that makes any pretense at conservatism. Of course, the given corporation may be incurring expenses to acquire intangible assets which will produce income for a number of years and such expenses may properly be capitalized. The conservative practice is to give the intangible assets a reasonable value at the inception and to write them off over their period of usefulness. A patent, for example, with a life of seventeen years, may easily lose its value through competition with some other device, by change in fashions, or from some similar cause. It would be more conservative, therefore, for the value of the patent to be written off over a period of ten years than over the full period of seventeen years.

On the other hand, even after the expiration of a patent, there may still remain a valuable asset in the form of goodwill created by years of association in the minds of the public of one trade mark with a patented article. For example, after the expiration of the Bayer patent for the manufacture of aspirin, other companies manufactured the product. Many users of aspirin, however, still insist upon buying Bayer's. Thus the patent, in effect, has had a life of more than seventeen years.

Reserves. In addition to analyzing the assets to see whether a surplus really exists, the needs of the business must be examined to see whether any part of the earnings or surplus should be retained for specific purposes. The amount of cash or liquid assets available with which to pay a dividend is, of course, always the principal factor limiting the amount that can be distributed. Nevertheless, many corporations consider it desirable to show, as a matter of information, the extent to which retained earnings should be considered to be unavailable for distribution by reason of specific future contingencies or other needs. Such needs are recorded by the creation of "reserves."

Any discussion of the subject of reserves is fraught with a certain amount of confusion because of the many meanings that have been given to the word in the past in accounting and financial practice. It may be well, therefore, to clarify what a reserve is and what it is not, and to distinguish between reserves and funds.

A reserve is an accounting device for reducing the carrying value of an asset, recording a known or contingent liability, or appropriating

whom nothing makes so great an appeal as demonstrated income. It is natural, therefore, that the management should seek to keep up the record of dividend payments. Remember that the policy of paying dividends at the expense of maintenance does not involve taking money physically from one place and using it in another, it consists most frequently of insidious procrastination in making repairs or inability to comprehend how new equipment may be necessary to keep abreast of new times.

accumulated profits. Accounting organizations for some time have been suggesting the substitution of other terms for the word "reserve" and it is probable that in time the word itself will become obsolete in accounting nomenclature. In this explanation we shall use the word "reserve" as a concession to precedent, but shall point out suggested substitutions for the term.

For the purposes of this discussion, reserves are divided into three classes:

1. *Valuation reserves,* which are used to accumulate the portion of long-lived asset costs that has been charged to past operation, or to reduce assets to estimated realizable values.
2. *Liability reserves,* which show an estimated accrual for a known liability, the amount of which may be somewhat indefinite.
3. *Surplus reserves,* which are an appropriation of retained earnings, usually to earmark its dedication to some specified purpose or to guard against some possible contingency.

Each type of reserve will be explained more fully below. Reserves of the first two types are created by charges to income, and reserves of the last type are chargeable to retained earnings. In other words, when charged to current income, the reserve represents a provision for losses and expenses that can be regarded as a proper charge to current operations. For example, a reserve for depreciation comes under this classification. Reserves chargeable to retained earnings provide for a possible loss or expense not regarded as a proper charge to current operations on an accrual basis, or represent an appropriation of retained earnings to indicate the extent to which it is not available for dividends.

Funds distinguished from reserves. Whereas a reserve is only an accounting entry, a fund is an actual asset, usually in the form of cash or securities. A fund may be set aside for the same purpose as a reserve, although this is only likely to occur in the case of surplus reserves. Creating a surplus reserve for a specific purpose makes the amount of the reserve unavailable for distribution as dividends; funding the reserve protects the working capital position of the company by restricting cash dividend payments and also gives assurance that funds for which the reserve is created will be available when needed.

Valuation reserves. A valuation reserve either represents a write-down in the carrying value of an asset or is a reflection of the portion of the cost of a long-lived asset that has been charged to past operations. Such a reserve is created by a charge to income for the period and is shown on the balance sheet as a deduction from the asset to which it applies. Valuation reserves may be applied to accounts receivable, investments, marketable securities, plant and equipment, patents, and intangibles that have a limited life.

Accounts receivable. Accounts receivable lose value through inability of the company to collect all outstanding accounts. A provision is customarily made, therefore, for bad debts (and sometimes for the estimated amount of allowable discounts, freight deductions, and similar items), and the amount provided is charged against the earnings for the period in which the sale took place. The trend is away from calling this provision a reserve for bad debts and toward referring to it as an "allowance for bad debts."

Investments. Long-term investments in subsidiary companies or those held for purposes of control and business advantage are customarily carried at cost. However, when there is evidence that there is a permanent decline in value below such cost, it is accepted accounting practice to provide a reserve for the difference, charging the amount against income of the year in which the decline in value becomes apparent. The suggested alternative for the word "reserve" in such a case is "estimated decline in value," or some similar expression.

Marketable securities. Marketable securities are usually carried in accounts at the lower of cost or market value. Small fluctuations may be ignored, but when there is evidence that a significant decline in value from cost has occurred, accepted accounting practice requires that the difference be charged to current operations and credited to a reserve. Current terminology for such a reserve is "provision for decline in value," or "amount to reduce to market value," or a similar expression.

Other valuation reserves. The methods of establishing provision for depreciation on *plant and equipment* were explained at pages 356 *et seq*. The treatment of *patents* was discussed at page 393.

Liability reserves. A liability reserve is an estimated accrual for a known liability, the amount of which may be indefinite but can be estimated with a reasonable approach to accuracy. The most common liability reserves are those set up for taxes, insurance, and interest. They are actual current liabilities and not properly classifiable as reserves. Good accounting practice calls for listing them among the current liabilities and for avoiding the use of the word "reserve" for amounts so accruable.

Obligation reserves. Some trust indentures executed in connection with bond issues require the creation of a sinking fund reserve as well as a sinking fund. The object of the reserve is to avoid a depletion of the working capital, which might handicap the company in its operations and thus reduce its future profits and make future sinking fund deposits impossible.

Pension and welfare reserves. Many corporations have adopted employee pension plans under which the company is obligated to pay

annuities to retired employees. Today, most pension plans are funded; that is, funds are put aside by payments to an insurance company or to a trustee to meet the pension obligations of the employer. However, some companies have plans under which no funds are actually accumulated in advance of the employee's retirement. Instead, the company sets up a pension reserve account in advance of distribution, crediting the reserve annually with the amount necessary to pay pensions. The company must consider its need for cash to meet pensions as it does its need for cash to operate its business. This is a decided disadvantage of an unfunded plan.

A reserve for pensions is an obligation reserve. However, if it is not funded, the reserve is a surplus reserve rather than a liability reserve.

Surplus reserves. Reserves representing restrictions on retained earnings are always created by a charge to retained earnings. As such, these reserves represent net worth and are part of the stockholders' equity. Regardless of the reason for their creation, they continue to be part of retained earnings and, when no longer required, must be returned to the retained earnings account. Their balance may not be used to absorb charges for expenses or losses. Their only use is to inform the user of the statement that a portion of retained earnings is restricted and may not be used as a basis for dividends.

Statutory restrictions. The corporation laws of several states require that certain restrictions be placed on retained earnings. A common statutory restriction is that whenever a corporation acquires any of its own shares, retained earnings must be restricted in an amount equal to the cost of the treasury stock.

Contractual restrictions. Frequently, a bond indenture will include a clause restricting dividend payments until the bonds are repaid. Another restriction may be found in preferred stock certificates. A clause may call for a retirement of the preferred stock out of earnings with a corresponding restriction on the amount of retained earnings available for dividends on the common stock. (See also sinking fund bonds, pages 154 *et seq.*)

Management (voluntary) restrictions. Both *contingency* and *future planning reserves* are voluntary on the part of management. The latter are created when management desires to show that a part of retained earnings is not available for dividends in order to facilitate an accumulation of working capital to finance some project, such as plant expansion. *Contingency reserves* represent provision for possible losses that might occur in the future. Examples are reserves created to provide for damages that may have to be paid as a result of a lawsuit, reserves to provide for possible declines in the value of foreign investments, or reserves to cover any general contingencies that might arise. It is to be noted that contingency reserves represent losses that may occur but

of which there is no certainty at present. When this certainty does arise, a contingency or liability reserve is in order. Charges or credits relating to such reserves do not enter into the determination of net income. When the contingency becomes a reality, the contingency reserve is transferred back to retained earnings, and the loss is treated through the income and assets accounts.

Suggested use of reserves. Current practice in setting up reserves and in presenting them in financial statements has been criticized as leading to confusion and misunderstanding. The modern view is to use the term *reserve* only in connection with restrictions or appropriations of retained earnings. It is recommended that the use of the term in the balance sheet to describe deductions from assets (valuation reserves) or provisions for particular liabilities (liability reserves), and in the income statement, be discontinued.[6] Instead, substitute terminology, such as "allowance for depreciation" or "provision for bad debts" is preferred.

Analysis of sources of surplus. Having examined each of the assets to see whether a surplus really exists, and having provided for the special needs of the business by creating reserves, management must next analyze the sources of surplus and of capital surplus to see whether it would be good financial policy to pay dividends from them. It must also know whether there are any legal restrictions against distributing dividends from a surplus created other than from earnings.

Distributions from earnings. Earnings from operations, income from subsidiaries, and surplus accumulated from earnings of previous years are ordinarily considered available for dividends. How much shall be distributed, and in what form, are questions of financial policy. It is traditional in American business not to distribute all of a company's earnings but to strengthen the enterprise and prepare it for expansion by leaving part of the earnings in the business. It is also common practice to pay dividends from surplus accumulated out of earnings under two circumstances: (1) in lean years when the regular rate cannot be maintained out of current earnings,[7] and (2) as a "melon" or extra dividend, when the surplus becomes too large. The kinds of dividends and dividend policies will be discussed in the following chapter.

Availability of paid-in surplus for dividends. Having already pointed out how paid-in surplus is created, it remains only to indicate whether there are any restrictions against its use for dividends. The following

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[6] Accounting Terminology Bulletin No. 1 (Review and Resume), p. 27.

[7] An interesting study of dividend policies during the depression, based upon reports of 348 corporations, indicated that the number of corporations that dipped into their surplus to pay dividends during the business cycle 1929–1935 increased rapidly in 1930, reached a peak in 1931, declined a bit in 1932, and then fell off sharply. See R. L. Tebeau, "Dividend Policies During the Depression," *Dun's Review*, April 1938.

tabulation shows how the common sources of surplus are generally regarded from the standpoint of availability for dividends.

Sources ordinarily considered available for dividends:

1. Earnings from regular operations.
2. Earnings accumulated from previous years.
3. Income from subsidiaries.

Sources available for dividends only under certain conditions, or not available for dividends:

1. Profit from the sale of appreciated property. If the property sold was unnecessary, the profits may be distributed, but if the property sold is to be replaced by similar property, the profits would not be actually "realized" and would not be distributed in dividends.

2. Conversion of unnecessary reserves. It is advisable for the directors to inform the stockholders of the change in the reserves and to leave the amount in surplus for some time before using it for dividends. The directors thus do not subject themselves to suspicion.

3. Surplus from merger and purchase of subsidiaries. The surplus received from constituents must be analyzed as to its source and divided into that which is ordinarily available for dividends and that which is not, and treated accordingly. The use of surplus from this source for dividends may be circumscribed by the statutes under which the merger was effected.

4. Revaluation of assets. Only the portion of the increased value that represents adjustments due to excessive provisions for depreciation in the past or erroneous charges of capital expenditures would be available for dividends. The portion of the increase based on reappraisals that give effect to unearned increment ordinarily would not be considered available for dividends.

5. Surplus created by reduction of capital stock. Where the reduction of capital stock has been made in order to eliminate a deficit or to write down the value of the assets, or for a similar purpose, any surplus created in the process would ordinarily not be used for dividends immediately. However, it might open the way to later distributions from earnings.

6. Donated surplus. Since donated surplus arises from gifts of assets usually made to help the corporation over a period of stress or to induce it to undertake certain projects, it is ordinarily not considered available for distribution.

7. Sale of securities at a premium. Dividends should not be paid from this source unless the stockholders and bondholders knew before they paid for their securities that a part of their money would be used for dividends.

8. Amounts credited to paid-in surplus upon the sale of no-par stock. This should be treated in the same way as a surplus from a sale of securities at a premium.

Legal rules governing payment of dividends. The law in most states is that dividends may be paid to the extent of surplus.[8] In some states, such as Delaware, a corporation may pay dividends out of current net profits even if it has no surplus. A few states, on the other hand, are more restrictive and permit the payment of dividends only to the extent of "earned surplus." In some states unrealized appreciation of assets (see page 398) is considered a part of surplus for determining the source of dividends.[9] Other states specifically prohibit considering unrealized appreciation as a source of dividends.

Some states express the general rule by declaring that dividends may not cause an "impairment of capital," i.e., before and after the payment of a dividend, net assets must not be less than stated capital (net assets being assets minus liabilities).

Basically the dividend laws were intended to protect creditors and therefore prohibit payment of a dividend while a corporation is insolvent or if the dividend payment will cause insolvency. Special note should be taken of the "nimble dividend statutes," [10] which permit the payment of dividends by a corporation which is insolvent in the bankruptcy sense, i.e., its net assets are less than stated capital. But these statutes often qualify the provision permitting use of net profits as a source of dividends by holding directors liable to creditors if the corporation is insolvent at the time of, or rendered insolvent as a result of, the payment of the dividend.[11]

Charter and other restrictions against dividends. In addition to the restrictions imposed by the corporation laws of the state in which the

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[8] Of course, dividends are actually paid out of cash, but the limit on the amount of the dividend is measured by the surplus account.

[9] Randall v. Bailey, (1942) 288 N.Y. 280, 43 N.E. (2d) 43

[10] The name "nimble dividends" has been given to dividends allowed to be paid out of profits of a particular period despite the existence of a deficit in accumulated earnings. Nimble dividends are permitted by the laws of California, Delaware, Georgia, Kansas, Minnesota, Montana, Nebraska, and Oklahoma. "Nimble Dividends: Some States Do Permit Dividends Despite Deficit in Accumulated Earnings," Eleanor McCormick, *Journal of Accountancy*, September 1949, pp. 196–207.

[11] The modern trend may be seen in the Model Business Corporation Act (prepared by the Committee on Corporate Laws of the American Bar Association). Between 1950, when the Act was first considered, and 1957, five states substantially adopted its provisions in regard to dividends. Other states are known to be considering its adoption. The Act limits dividends to "unreserved and unrestricted earned surplus." Surplus is defined as "the excess of the net assets of a corporation over its stated capital" while earned surplus is defined as "the portion of the surplus of a corporation equal to the balance of its net profits, income, gains and losses from the date of incorporation, or from the latest date when a deficit was eliminated . . ." The term "unreserved" is used to exclude the reserves of earned surplus which the directors may create for any proper purposes and which they may also abolish. "Unrestricted" is used to exclude the restrictions on surplus required under the Act when a corporation acquires its own stock. See W. P. Hackney, "The Financial Provisions of the Model Business Corporation Act," 70 *Harvard Law Review* 1357 (1957), and A. M. Kreidmann, "Dividends—Changing Patterns," 57 *Columbia Law Review* 372 (1957).

company is organized, there may be other restrictions such as the following:

1. Charter restrictions that set up conditions precedent to payment of dividends on common stock. The most usual of these are those calling for dividend payments first on the preferred stock and other prior stocks. Another example is the restriction that dividends shall not be payable on common stock unless the net quick assets and net earnings are maintained at a fixed minimum.

Another charter restriction may be imposed by the cumulative provisions of the preferred stock. Thus, if the preferred stock is cumulative, arrearages must be made up in subsequent years before any dividends may be declared on the common stock.

2. By-law restrictions. These are not common, but they may exist.

3. Clauses in bond indentures and bank loan agreements restricting dividend payments while the securities or loans are outstanding. For example, the indenture or loan agreement may provide that after payment of dividends, the earned surplus and the net quick assets must equal a certain amount.[12]

4. Restrictions imposed by regulatory statutes such as the Public Utility Holding Company Act of 1935, the Interstate Commerce Act, the Motor Carrier Act, the Federal Water Power Act, and the Federal Communications Act.

Rights of stockholders to compel a dividend. The right to declare a dividend belongs primarily to the directors. Stockholders, however, can compel the declaration of a dividend under the following circumstances: (1) If the statute or contract under which the stock is issued requires the directors to pay dividends to the stockholders in each year in which there are sufficient earnings. (2) If the stockholders seeking to compel a declaration of a dividend can convince a court that the directors have acted fraudulently, oppressively, or unreasonably in refusing to declare a dividend when the corporation has a surplus that it can divide among its stockholders without detriment to the business. The courts will not interfere, however, with the discretion of the directors if the latter have acted in good faith, without fraud, without abuse of discretion, and in a manner that is not unjust or oppressive to minority stockholders. Nor will they interfere merely because the corporation has a large surplus.

It is very hard to lay down a rule that can be applied in all cases where the stockholders seek to compel directors to pay a dividend on

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[12] Under the Indenture for the 2¾ per cent debentures, due 1964, the Air Reduction Company, Inc. may not pay dividends on its common stock unless, after the dividend has been paid, the consolidated net working capital of the Company and its subsidiaries is at least $20,000,000.

the ground that not to pay it would constitute a fraud. In every case the facts are likely to be so complicated that a decision can be rendered by an equity court only after all the circumstances have been gone into very carefully. While the courts will not substitute their discretion for that of the directors, they will not wait until actual fraud has been proven before taking action. The order directing The Ford Motor Company to pay a dividend at the instance of the Dodge interests is a case in point.[13]

Illegal dividends. In most states directors are liable to the corporation and, in case of insolvency, to creditors for a dividend unlawfully paid. Directors who dissent from the declaration of the illegal dividend or were absent from the meeting at which the illegal dividend was declared may be relieved of liability by statute. In any event, a dissenting director should note his dissent on the minutes of the meeting. If he was absent from the meeting at which an illegal dividend was declared, immediately upon learning of the declaration of the dividend he should inform the board of directors of his dissent, in order to avoid liability for the acts of his co-directors.

Stockholders may also be liable for receiving illegal dividends if it is shown that they deliberately or negligently participated in the unlawful declaration, or accepted the dividend knowing it was illegal. On the other hand, a stockholder would not be liable for innocently receiving a dividend if the corporation was not insolvent at the time of payment. In states having the impairment of capital test, i.e., net assets must not be less than stated capital before and after payment of the dividend, a stockholder may be compelled to return a dividend that impaired capital.

Research Question

From the last three annual reports of any two corporations in the same industry determine: (a) what percentage of the plant and equipment was charged off in depreciation each year, (b) what liability reserves were set up, and (c) what contingency reserves or other surplus reserves were set up.

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[13] The Ford Motor Company was compelled to declare a dividend, the court holding the refusal of the directors to declare a dividend of more than $1,200,000 when the corporation had a surplus of $112,000,000, about $54,000,000 of cash on hand, had made profits of $59,000,000 in the past year, and had expectations of $60,000,000 the coming year, to be, in the absence of some justifiable reason, an arbitrary exercise of authority which would give a court of equity the right to interfere. Dodge v. Ford Motor Co., (1919) 204 Mich. 459, 170 N.W. 668. Shortly after this decision, the elder Ford, working through purchasing agents who were obliged to keep the identity of their principal secret, bought out the interests of the minority stockholders. John and Horace Dodge, the plaintiffs in the dividend case, and two others, each received $12,500,000 for their stockholdings in the Ford Motor Co. The story is told in *The Legend of Henry Ford,* by Keith Sward (New York: Rinehart & Company, Inc., 1954), pp. 71–74.

Problem

1. For each of the following situations, describe the reserve that should be set up and characterize it as a valuation, liability, or surplus reserve:
   (a) The Prall Corp. has agreed with the employees' union to pay a pension of $100 a month to employees when they reach the age of 65.
   (b) The Stall Corp. plans to pay its employees a similar pension but it will do so voluntarily and not under a plan.
   (c) The Beep Corp. has made exceptionally high profits this year but is worrying over possible losses on its high inventory since prices are expected to drop.
   (d) The Digit Mining Corp. has set up reserves for depreciation but has done nothing about the wasting asset. It is also concerned with the high cost of replacing certain buildings within four or five years. The amount charged to depreciation will equal the cost of the buildings when they reach the end of their life but will not equal the cost of replacement.
2. The following transactions constitute changes in the surplus account of the corporation. Indicate (a) whether paid-in surplus or earned surplus is affected and (b) whether the increase is available for dividends.
   (a) The corporation sells $10 par value common stock for $15.
   (b) The corporation buys land appraised at $75,000 for $50,000 worth of common stock. The property will be carried at $75,000 on the books.
   (c) A town where a factory is to be located donates property worth $200,000.
   (d) The property acquired in (b), above, is sold for $100,000; the proceeds are not to be reinvested in other property.
   (e) The corporation receives $10,000 in dividends on its General Motors and U.S. Steel securities.
   (f) The corporation sells at a gain its General Motors holdings which it considered a temporary investment.
   (g) The reserve for inventory losses is no longer needed and is returned to surplus.
   (h) The corporation buys back its own bonds in the market at less than par and retires them.
   (i) It buys its own preferred stock at less than par and retires it.

CHAPTER 20

Dividend Policies

Factors involved in considering dividend payments. After the directors have studied the surplus situation of the corporation, have reviewed the reserve policies, and have created the necessary reserves or added to existing ones, they are ready to consider the declaration of a dividend. Such consideration calls for a review of the company's past dividend policy and a determination of whether it should be continued or changed in the light of the current situation. In other words, the directors must answer the following questions: (1) In view of the size of the surplus, the company's working capital position, its plans for expansion, its need for short-term and long-term capital, and the availability of funds for these needs, what shall the company's dividend policy be? (2) What kind of dividend shall be declared?

The principles governing dividend policy will be clearer to the student if he first has an understanding of what kind of dividends can be paid. The discussion, therefore, will proceed as follows:

1. Kinds of dividends.
2. Dividend policies.
3. Declaration and payment of dividends.

Classification of dividends. Dividends may be classified on the basis of the medium in which they are paid, that is, whether they are paid in cash, stock, property, or scrip. They may also be classified in regard to whether they are distributed from profits or from capital. Dividends from capital are known as liquidation dividends. Dividends may also be classified as "regular" or "extra."

Each of these kinds of dividends will now be described; regular and extra will be explained in connection with the discussion of dividend policies, at page 413.

Cash dividends. Most dividends are paid in cash. The planning necessary to have the cash available was explained at page 311, in the

chapter on working capital. Cash dividends are ordinarily paid from retained earnings. Under unusual circumstances, a cash dividend may be distributed from paid-in surplus. Suppose, for example, that a company has effected a sale of a portion of its business for cash; its capital accounts show a large paid-in surplus traceable to the allocation of part of the proceeds from a sale of no-par stock; it has no accumulated earnings from which to pay dividends. If the cash received from the sale of assets were not needed for conducting the business, the directors would be justified in declaring a cash dividend and charging the distribution to paid-in surplus.

The question sometimes arises as to whether a corporation that has a surplus, but whose cash is tied up in non-distributable assets, can borrow money with which to pay dividends. The answer is undoubtedly yes. But the question of expediency is not so easily answered, for there are times when borrowing money with which to pay dividends is not inexpedient.

Take this situation. A company is expanding quite rapidly. It is going to need new capital, which it will be inexpedient to raise through a bond issue. A prime requisite to the economical sale of its stock is to give that stock a good rating; this aim can be accomplished by establishing and maintaining a fair dividend rate. To meet the dividend requirements, temporary loans may be sought and stock sold, and thereafter the company can use its earnings for dividends instead of having to "plow" them into the property.

To be sure, corporations would hardly attempt to raise a loan ostensibly for a dividend payment. Instead, they borrow money for operating purposes and use the cash from revenues to pay the dividend.

Stock dividends. A stock dividend is a distribution of additional shares of stock to existing stockholders on a pro rata basis—that is, so much stock for each share of stock held. A stock dividend can be more or less than 100 per cent. Thus, a 20 per cent stock dividend would give a holder of 100 shares an additional 20 shares, whereas a 250 per cent stock dividend would give him 250 additional shares. When a stock dividend is declared, earnings are capitalized, that is, the dollar amount of the stock dividend is transferred from the corporation's retained earnings account to its capital stock account.

Where control is not a factor, as is the case with the great majority of stockholders of large corporations, the distribution of a stock dividend enables stockholders to get immediate cash returns through the sale of the stock received. At the same time, large stockholders may prefer a stock dividend since it enables them to postpone or avoid income tax on the dividend and to convert what would otherwise be ordinary income into long-term capital gain taxable at lower rates (see page 411).

A stock dividend is usually charged to retained earnings, but at times is charged to paid-in surplus. Distributions from the latter account call for careful consideration of the source of the surplus, for some sources may constitute a sound basis for a stock dividend whereas others may not. For example, suppose the company owned lands on which valuable natural resources were discovered and a capital surplus was created through a reappraisal to reflect the unearned increment. A stock dividend from such a source would not be open to criticism. On the other hand, if it reappraised the value of marketable securities it owned to reflect a rise in their value, and credited the unrealized appreciation account in the amount of the increase, the distribution of a stock dividend based on that account would be unsound because the market value of the securities would be subject to fluctuation.

Any stock dividend distributed from paid-in surplus or unrealized appreciation calls for a full disclosure of the sources to the stockholders.

A stock dividend may be payable in preferred or common, but a distribution to a particular class of stockholders cannot usually be made if the effect would be to deprive the stockholders of any class of their rights. Thus, if there is preferred stock outstanding, a dividend of preferred stock given to the common stockholders and not to the preferred stockholders would impair the rights of the preferred stockholders and would therefore not be permissible.

Although the declaration of a stock dividend is within the power of the directors, the matter may have to be submitted to the stockholders if the corporation has to amend the certificate of incorporation to increase the amount of capital stock. Most companies maintain enough unissued stock to be able to declare stock dividends at a moderate rate.

Reasons for declaring a stock dividend. Two principal reasons usually actuate the directors to declare a stock dividend. (1) They consider it advisable to reduce the market value of the stock and thereby facilitate a broader distribution of ownership. (2) The corporation may have earnings but may find it inadvisable to pay cash dividends. The declaration of a stock dividend will give the stockholders evidence of the increase in their investment without interfering with the company's cash position. If the stockholders would prefer cash to additional stock in the company, they can sell the stock received as a dividend.

Sometimes a stock dividend is declared to protect the interests of old stockholders when a company is about to sell a new issue of stock. A concrete example will make the principle clear. A corporation was organized by several persons who from time to time added investments to the business and drew no dividends. Earnings were "plowed into the business" till the time arrived when it was necessary to get

a considerable amount of new capital from outside sources. At that time the surplus exceeded the amount of capital stock outstanding; the capital stock, therefore, was worth considerably more than par. To get investors to pay more than par for their stock was known to be extremely difficult; if stock were sold to them at par, part of the surplus of the company would have been presented to them gratuitously. To escape this difficulty a stock dividend was declared before the new stock was offered to outsiders. Thus the sole ownership of the surplus was transferred to the old stockholders.

Relation of taxation to stock dividends. Under the provisions of Section 305 of the Internal Revenue Code, the general rule is that no tax is imposed upon the receipt by a stockholder of a stock dividend. There are only two exceptions to this rule: The dividend is taxable if (1) the distribution of stock is payable, at the election of the stockholder, in cash or other property; or (2) the distribution of the stock is made in discharge of dividends on the corporation's preferred stock for the current or preceding tax year.[1] The fact that the stock dividend is paid in a class of stock other than that of the shares on which declared does not affect the taxability of the stock dividend.

Property dividends. Any asset, or any part of any assets, if physically divisible, may be paid out as dividends if there is a legal source for dividends, i.e., a surplus. Usual examples are stock of subsidiaries and stock held as investments or acquired in reorganizations. Thus, Standard Oil Co. (Indiana), which prior to anti-trust action in 1911 was a subsidiary of Standard Oil Co. of New Jersey, owned a considerable block of stock in Standard of New Jersey. Starting in 1948, the Indiana corporation each year, in addition to cash dividends, paid out shares of Standard of New Jersey stock. Occasionally a corporation has been known to pay dividends in the form of merchandise owned or produced by it. Distribution in the form of a dividend may be resorted to rather than a sale and the distribution of the cash, in order to prevent a decline in the price of the stock that would result from a sale of any large block.

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[1] If a stock dividend is not taxable, it is treated as a dilution of the value of the shares. For example, if 100 shares of stock cost $9,000, the basis of each share is $90; if the stockholder receives a non-taxable stock dividend of 50 shares of the same stock, the income of the recipient is not thereby increased for the year but the basis of each of the old and new shares for determining gain or loss on a future sale is $60 ($9,000 ÷ 150). The date basis of the new shares is the same as the date basis of the old shares.

If the stock dividend is taxable, the new shares represent income to the extent of their fair market value. For example, 100 shares of stock cost $9,000. If the stockholder receives a taxable stock dividend worth $5,000, he includes $5,000 in taxable income; the basis of the old shares for determining gain or loss on a sale remains $9,000 and the basis of the new shares is $5,000.

A stockholder cannot be compelled to take the property distributable to him on account of a dividend. If a stockholder should refuse to take the property dividend, the company may retain it in trust for him or possibly sell it for his benefit. He does not have the option to receive an equivalent amount of cash in lieu of a property dividend.

Scrip dividends. A scrip dividend is a distribution of surplus to the stockholders in the form of notes or promises to pay the amount of the dividend at a certain time. The notes are called "dividend certificates" or scrip. They usually bear interest at a fixed rate from the date of the note. A corporation will consider paying a dividend in scrip under the following circumstances:

1. The corporation has current earnings but insufficient cash to warrant payment of a cash dividend. The directors feel, however, that they ought to give the stockholders of the present the earnings of the immediate past instead of withholding all title to these earnings for the benefit of future stockholders.

2. A stock dividend would not be wise because future earnings are not expected to increase sufficiently to permit regular dividends on the increased amount of stock that would be outstanding.

3. The corporation wants to maintain an established dividend record without paying out cash immediately.

Dividends payable in stock or cash. Under the following circumstances it may serve the corporation's purposes to declare dividends payable in stock or cash at the option of the stockholder:

1. A program of expansion makes reinvestment of earnings advisable, and it is expected that most of the stockholders will accept the stock dividend. This situation applies especially to closely-held corporations where it is easier to determine in advance whether most stockholders will accept the stock dividend.

2. If earnings have been rising rapidly, the choice may satisfy the investors in preferred stock who look for an opportunity to participate in increased profits.

The corporation informs the stockholder that he may either receive his dividend in cash or apply the cash to the purchase of additional stock. Choice must be made within a certain number of days after receiving notice. Some companies that establish the cash or stock dividend as a definite policy arrange that all dividends be paid in cash unless notice to the contrary is received from the stockholder; others apply all dividends to the purchase of shares in the absence of an election to receive dividends in cash.

The arrangement calls for preparations similar to those necessary when a stock dividend is to be declared, as well as facilities for

handling the administrative work involved in permitting the choice.[2]

Liquidation dividends. Dividends paid in the ordinary course of business and not as a step toward the complete or partial suspension of operations are properly designated "profit dividends," whereas dividends paid out of properties that are being surrendered, whether paid in kind or first converted by the company into cash or some other form of wealth, are called "liquidation dividends." It will be noticed that the distinction here does not turn on the question of whether the dividends are paid out of current earnings or out of accumulated earnings. This classification is important, not only in connection with income tax problems,[3] but also in connection with distributions to different classes of stock.[4]

A definite dividend policy. Having explained the kinds of dividends, we are now prepared to discuss dividend policies. A company, to be successful, must have a plan for obtaining funds to operate its business, as well as a plan for the profitable use of the money available. These plans represent its financial policy. One of the elements in establishing financial policy is an objective for the payment of dividends on common stock. That objective is reflected in the company's dividend policy. The possible policies are:

1. A period of no immediate dividends.
2. Payment of regular dividends.
3. Payment of regular and extra dividends.
4. Payment of irregular dividends.
5. Payment of regular stock dividends for a certain time.
6. Payment of regular dividends plus stock dividends.

Preliminaries to discussion of dividend policy. Before the merits of each of these policies can be intelligently discussed, the following matters require consideration:

1. Advantages of stable dividends.
2. Influences on selection of dividend policy.
3. Necessity for satisfying the equities between present and future owners.
4. Tax consequences of dividend action.
5. Stock split-ups in relation to dividend policy.

Advantages of stable dividends. The final aim of a corporation should be the declaration of dividends on common stock at a fairly

[2] In instances where the dividend is payable in cash or stock at the option of the stockholder, the stock dividend is taxable under the Federal income tax law.

[3] Under the Federal income tax laws, a distribution in complete or partial liquidation, as those terms are defined in the statute, is treated in the same manner as a sale of his proportionate interest by the stockholder. The income tax gain or loss is computed accordingly.

[4] For further discussion of distribution upon dissolution, see page 558.

stable rate, year in and year out.[5] Stockholders, of course, have the right to expect that as prices of all commodities and services increase, their income also will increase. A stable dividend policy, therefore, does not mean an inflexible policy, but one that involves the payment of a fair rate of return, taking into consideration the gradual growth of the business and the gradual evolution of external events.[6]

The advantages of stable dividends are:

1. It aids in long-term financing. If a company anticipates having to raise new capital some time in the future, it must keep in mind that today's operations will be part of the record that investors will examine critically in deciding whether or not to purchase the company's securities. A stable dividend record makes financing easier.
2. It eases the problem of long-term planning.
3. It improves the company's credit and increases as well as stabilizes the market value of securities outstanding.
4. It creates stockholder confidence in management.

Small dividends, therefore, are preferable to no dividends.

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[5] From 1922 through 1939 there was a marked degree of irregularity in dividend payments even among corporations that in previous years had maintained a regular rate. The change indicated not an abandonment of the principle that a stable dividend record is advantageous to the corporation, but a tendency toward adjustments in capital structures resulting from the expansion of business units in the first part of the period mentioned and from operations at a loss during the depression period. Thus in the period mentioned, many corporations increased their capitalizations, giving stockholders the right to subscribe to new issues of stock at prices below the book value of the stock, others changed from par value to no-par value shares; still others lost their identity in mergers with larger corporations or grew in size by the consolidation movement, and many split up their shares, giving old shareholders anywhere from two to five new shares for each original share. Following the depression period, many readjustments occurred to remove accumulated preferred dividends. Changes such as these frequently affect the dividend rate and make comparison with earlier years difficult.

For comment on dividend payments following World War II, see note 7, page 410.

[6] Approximately 85 companies with a record of at least 50 consecutive years of cash dividend payments are listed on the New York Stock Exchange. Among these are:

	Year Consecutive Payments Began
Pennsylvania Railroad Co.	1848
Pullman, Inc.	1867
Westinghouse Air Brake Co.	1875
American Telephone & Telegraph Co.	1881
Diamond Match Co.	1882
Standard Oil of N. J.	1882
Procter & Gamble Co.	1891
General Electric Co.	1899
National Biscuit Co.	1899
United Fruit Co.	1899

Many of these companies have paid stock dividends in addition.

Other reasons for maintaining stable dividends. Aside from the advantages of stable dividends, there may be other reasons for striving for a good dividend record.

In some states the bonds of railroads and public utilities cannot become eligible as legal investments (see page 214) unless the company has an unbroken dividend record of five years. One break in the record may disqualify the securities for a period of five years. For that reason such companies should conserve their resources in such a way that dividends will be paid out of accumulated surplus even when not earned currently.

Dividends are taxable in the year they are received by the stockholders and not in the year the earnings to pay them accrue. Every reader of this book probably has had enough experience with the income tax to know that the rates are graduated; that the larger the dividend the higher the rates. Hence a corporation should not accumulate its profits and then distribute them in one year, thus making them subject to higher income tax rates in the hands of its stockholders than if they were distributed evenly, year after year.

Influences in determining dividend policy. No decision concerning dividend action can be made without first examining all of the factors that bear upon the company's immediate and future financial condition. The examination of the surplus to see whether a dividend can be declared from a legal and financial viewpoint involves, as we have seen, the review of certain business factors, especially in connection with the establishment of reserves. There are usually other factors, not necessarily considered when surplus is examined, that must be taken into account. These factors include:

1. The stability of the company's earnings. The record of earnings over the past five or ten years and the frequency of periods resulting in operating deficits guide the directors in their current dividend decisions. In that connection, the business outlook when the payment of a dividend is under consideration is important. Although dividend distribution is usually based on the earnings of a past period, the directors must take into account what is immediately ahead for the company. It must consider the general economic outlook and how it is likely to affect the business.[7]

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[7] Because directors take all factors into account, especially general economic and market conditions, it is possible to observe definite trends in dividend payments and to explain them. Thus, in the years following World War II, less than half of corporate net earnings were distributed to stockholders as compared with ¾ in 1939 and ⅔ in 1929. In 1947 and 1948, combined dividend payments by all companies listed on the New York Stock Exchange gained only moderately, nowhere near keeping pace with the rise in earnings. The greater equity of stockholders showed up in mounting book values. The conservative policy was dictated by the difficulty of obtaining new capital during those years. Companies were trying to avoid financial

2. The need for retention of earnings either to build up working capital or to expand fixed assets. A company that wants new equity capital must be prepared to pay a return on that capital. For example, utilities that are regularly in need of new capital, on the whole, pay out more of their earnings in dividends than other segments of industry. As a consequence, they may have less accumulated surplus than industrial companies.

3. Characteristics of the stockholders. Where stock is closely held, the needs of the owners are considered. Where stock is widely held, it is usual to declare dividends on the basis of profits earned within two or three years of the date of declaration. If a company must look to small investors for capital, a liberal dividend policy may be necessary. A company with many small investors should have in mind the needs of the average stockholder. It must assume that most of these stockholders have been attracted to the common stock by the greater return that they will receive on their investment as compared with the return they would get if their savings were placed in insurance, government bonds, or savings deposits. The characteristics of the stock ownership as a whole are too often ignored by stockholder-members of the board of directors who influence dividend policy to suit their own individual needs and preferences.

Tax consequences of dividend action. The tax consequences of dividend action must be considered from the viewpoint of the stockholders and the corporation. The stockholders' viewpoint is often important where there are a few major stockholders or where the company is closely owned. A stockholder whose income is already in the high-income brackets may prefer not to have liberal distributions of taxable dividends, but would favor non-taxable stock dividends or a reflection of the company's increased prosperity in a higher market value of the shares owned. In any sale of the stock, the gain would be taxable under the capital gain and loss provisions of the income tax law and would be subject to a maximum tax of 25 per cent if the securities have been held for more than six months.[8] However, from the corporation's viewpoint, there is always the necessity of considering the dangers of accumulating unnecessary surplus and subjecting the corporation to the penalty tax imposed by Sec. 531 of the Internal Revenue Code.

structures top heavy with debt and were making up deficiencies in depreciation allowance. "Capital Formation and the Equity Market," by Winthrop Aldrich, *Commercial and Financial Chronicle*, Nov. 25, 1948, p. 2. Compare this with the data for 1955 and 1956. In 1955, corporate earnings were approximately $21,000,000,000; in 1956, $22,000,000,000. In 1955, cash dividend payments were $10,450,000,000; in 1956, $11,250,000,000. It can be seen that corporations paid out a larger share of their earnings in dividends in those years, although still nowhere as large a share as in the pre-war years.

[8] The six months period is figured from the date the stock was originally acquired, not the date of the stock dividend.

In arriving at a dividend policy, and especially an end-of-the-year dividend policy, directors must consider whether their company is vulnerable to the penalty tax imposed by Sec. 531 for improperly accumulating surplus. The test in almost every case is whether or not the surplus is beyond the reasonable needs of the business. The fact that a corporation accumulates earnings does not necessarily mean that the Sec. 531 tax will be incurred. But, if the Commissioner charges that the accumulation is for the purpose of preventing the imposition of income taxes on its shareholders and that the accumulation was not reasonable, the corporation must prove him wrong.

The following purposes (and others) may justify accumulations: to provide against contingencies or the hazards of the business; to set up necessary reserves; to finance an expansion program; to modernize or replace equipment; to increase inventory; and, probably, to provide against depreciation of inflated inventories.

Stock split-up in relation to dividend policy. A stock split-up is the process of issuing more than one share of new stock for each share of old stock with a corresponding reduction in the par or stated value of the stock so that the amount in the capital account remains unchanged. Thus, a company with authorized stock of 4,000,000 shares with a par value of $50 may split up its shares by reducing the par value to $25 and have as a result 8,000,000 shares. Each stockholder would receive two shares of the new $25 par value stock in exchange for one share of old $50 par value stock.[9]

From the standpoint of dividend policies, three reasons may make a split-up desirable: [10] (1) It permits a greater distribution of profits without raising the dividend rate. Thus, in the above illustration, if the company had been paying $2 a share on the $50 par value stock, the same dividend rate would permit a payment equivalent to $4 a share on the old stock. (2) It permits a reduction in dividend rate without reducing the stockholders' income. Thus, in the above illustration, if the company reduced its $2 dividend rate to $1, each stockholder would still receive $2 of dividends on the new shares. (3) It

[9] In 1956 the stocks of several companies were split because high prices had tended to make them unwieldy in the auction market. Some examples are Lukens Steel, split 3 for 1; Johns-Manville, split 2 for 1; and Procter and Gamble, split 2 for 1. Some companies split their shares in anticipation of possible needs for additional capital, knowing that a lower-priced stock would find more buyers.

For a study of stock split-ups and market prices, see the following articles by C. Austin Barker: "Effective Stock Splits," *Harvard Business Review*, January-February 1956, p. 101; and "Stock Splits in a Bull Market," *Harvard Business Review*, May-June 1957, p. 72.

[10] The student will understand the difference between a stock dividend and a split-up if he keeps in mind that the stock dividend involves a capitalization of surplus; in other words, on the books of the company there will be a transfer from surplus account to capital account. In the case of a split-up, there is no such requirement.

enables the company to report a smaller amount of earnings per share, which may be desirable where earnings per share are excessively large.

The lower market value per share resulting from the split-up may lead to greater marketability and consequently broader distribution of the stock. Incidentally, if all of the shares are not outstanding, the increase in the unissued shares may give the company greater leeway in acquiring new properties for stock.

Adjustment of capitalization through a reverse split-up (reduction in the number of shares by increasing the par or stated value) is sometimes undertaken to raise the price of depressed shares and pave the way for new financing (see page 509).

Determining the dividend policy. All of the factors affecting dividend policy having been considered, we may now see the circumstances under which each policy might be justified.

A policy of no immediate dividends. A board of directors may decide to pay no dividends, even though it has earnings from which it can legally do so. This policy may be justified under the following conditions: (1) the company is young and growing; (2) needed additional capital cannot be raised except at exceedingly high cost and earnings must therefore be plowed back into the business; (3) the stockholders are willing to wait for a return on their investment and in the meantime are content to have their holdings appreciate in value.

After a period of no dividends, while the surplus is increasing, it may be good policy to split the stock or to declare a stock dividend. The no-dividend policy must be used with caution because of the Federal penalty surtax under Sec. 531 on corporations that accumulate surplus beyond the reasonable needs of the business.

A policy of regular dividends, or regular and extra dividends. A policy of paying regular dividends on common stock means the establishment of a fairly stable regular dividend rate. To carry out the intention of maintaining a regular dividend rate, and at the same time to allow stockholders to share in additional earnings, the directors may adopt a policy of declaring extra dividends. It is not an unusual practice for corporations to pay extra "year-end" dividends after the results of the operations indicate that such extras are justified and are prudent to prevent penalty taxation under Sec. 531.

Extra dividends are frequently called "melons." The practice keeps the stockholders from expecting the increased rate in the future. As a policy, however, it may lead to year-in and year-out payment of extras until the extra dividend is as much expected as the regular. In that case, and if conditions warrant it, the directors may decide to go back to a regular dividend policy at an increased rate and drop the extra.

A word of warning should be given about extra dividends. Honest practice, it would seem, would require that extra dividends should not

be declared suddenly. Stockholders should have some warning in order that they may know what can be expected from their stock in case they wish to sell.

Sometimes the solutions of problems arising out of financial operations depend upon whether a dividend is a regular dividend or an extra dividend. For example, where bonds are convertible into stock and the stock is paying regular dividends, it is usual to allow the bondholder the stipulated rate of interest on his bond from the date of last payment to the time of conversion, but to charge him with an amount equal to interest on the stock at the rate of the regular dividend paid thereon from the date of conversion up to the date of the next regular dividend. Adjustments somewhat on the same basis may be made by a contract of sale between successive owners; for example, *A* sells stock to *B* to be delivered on a certain date, "adjustment to be made in respect to accumulated dividends." Although as a matter of law the right to a dividend does not arise until it is actually declared, a contract such as is here contemplated would justify the seller in requiring the purchaser to pay not only the stipulated price, but in addition the interest thereon from the date of last declaration of a dividend up to the time of delivery, at the rate of the regular dividend.

What is a regular dividend and what is an extra dividend is generally settled by the directors of the company. Large corporations usually number their dividends and label them as regular or extra. Sometimes the distinction depends on whether the dividends are paid out of current earnings or out of accumulated earnings. Where it is necessary to establish whether a dividend is regular or extra, recourse must be had to all the surrounding circumstances that bear upon the situation.

Policy to pay regular stock dividends. The conditions leading to the policy of paying regular stock dividends are the existence of earnings and the need to retain cash in the business. Few companies have adopted such a policy, for it is not generally regarded as advisable. However, corporations with expansion programs that require the outlay of large amounts of capital from year to year, which immediately result in greater profits, may justifiably adopt a policy of paying stock dividends regularly instead of cash dividends. The policy can apply only temporarily, however, for the constant cutting up of the corporate ownership into a larger number of shares may prove harmful in periods of lower earnings. Also, the value of the shares may fall below a desirable range, from the standpoint of later financing. Again, the surtax upon unreasonable accumulation of surplus is a deterrent to following this policy since the corporation may not resort to nontaxable stock dividends to reduce the amount of apparent surplus.

Policy to pay regular cash and stock dividends. A company adopts a policy of paying regular cash dividends plus a stock dividend when it

(1) wants to continue its record of regular cash payments, (2) has reinvested earnings that it wants to capitalize, and (3) wants to give stockholders a share in the additional earnings but cannot afford to use up its cash. These reasons have already been fully explained. The stockholders can always sell the extra stock received as a dividend and thus, in effect, have a cash dividend.

Policy to pay irregular dividends. A policy of irregular dividends is entirely appropriate for a company that has highly unstable earnings. The policy is based upon an attitude that stockholders are entitled to as much dividends as earnings and the financial condition of the company warrant. The board will therefore declare dividends at irregular rates at the regular dividend payment dates, or may even declare dividends from time to time without regard to regular periodic payments.

Dividend policies of wasting assets corporations. In a business having wasting assets, like timber, oil, and mines, unless management wilfully withholds from revenue and reinvests sums equal to the value of the property exhausted in earning its revenue, the dividends given to the owners will represent in part, a return of the owner's investment. For this reason, the dividend policy is determined in conjunction with management's objectives. Thus, if the objective is to liquidate when assets are depleted, the directors may declare dividends from the excess of the receipts over current disbursements, after providing for current working capital needs. The stockholder is informed, with each dividend payment, of the proportion of the payment that represents a return of capital since that portion is not subject to income tax. Or, if management's objective is to acquire new natural resources or nonwasting assets, it will distribute dividends from part of the earnings after depletion allowance and reinvest the balance in the purchase or development of such properties as will carry out its plans.

Declaring a dividend. The general practice is for the directors to declare a dividend at a duly convened meeting of the directors. The declaration is made by the adoption of a resolution which sets forth (1) the rate or amount of the dividend, (2) the class of stockholders to which the dividend is payable, (3) the date set for determination of who is entitled to the dividend, (4) the date when the dividend will be paid, and (5) the medium in which the dividend is to be paid.

Time of payment. Some companies, usually closely-owned ones, pay only an annual dividend; many companies pay semi-annually, but the vast majority pay their dividends quarterly. Stockholders favor a quarterly dividend, and this practice has become fairly standard for companies with listed securities.

Record date for payment of dividends. As indicated above, the resolution declaring the dividend includes the record date as of which holders of stock are entitled to the payment of the dividend. The pur-

pose of the record date is to give ample time for the transfer of stock certificates before the payment date. Stock exchange regulations usually require that the corporation allow at least ten days between the declaration date and the record date.

The general practice at one time was to close the books on the record date and not to open them for from ten days to two weeks, in order to give the secretary time in which to make up the list of stockholders to whom the dividend should be paid. Under modern practice, the secretary prepares a list of the stockholders from the stock record book on the day as of which stockholders become entitled to dividends. The transfer books are allowed to remain open and the records of transfers may be made without interruption. The dividend checks are sent to the persons whose names appear on this list and the company is discharged from liability if various persons claim the dividend by reason of ownership of the stock. If the directors do not indicate a record date as of which the stockholders are entitled to a dividend, it is assumed that the directors intended the dividend to go to the stockholders of record on the day of the passage of the resolution.

Disbursement of the dividend. A company may itself do all of the work involved in disbursing a dividend. However, most of the larger corporations appoint a dividend disbursing agent, usually the transfer agent of the company, to handle the preparation of the list of stockholders entitled to dividends and to attend to all the details of the payment. The corporation deposits a sum of money with the agent sufficient to take care of the dividend, and the agent draws against this sum in paying the dividend. This service is rendered for a fee.[11] After a dividend has been declared, the amount of the dividend is a debt against the company. If, before the dividend is actually paid, the company unexpectedly fails through some calamity, the stockholders have a right against the assets as unsecured creditors up to the amount of the unpaid dividend. If the company actually had set apart a fund to pay the dividend and then failed, the stockholders would have the right to this fund.

Who are entitled to dividends. Dividends must be divided among stockholders in proportion to their shares, though this rule, of course, is subject to the corollary that contractual rights represented by the classification of stock into common and preferred must be observed.

Unless there is a special contract to the contrary, stockholders of record on the day the dividend lists are made up are entitled to dividends, irrespective of when they became holders of the stock. In other words, dividends are not apportioned as is interest on bonds. For

[11] See *Prentice-Hall Corporation* service for a detailed description of the practices followed in paying dividends.

example, suppose a 1½ per cent quarterly dividend was declared on 6 per cent preferred stock payable September 1 to stockholders of record at the close of business August 15. If *A* bought a share of the stock from *B* on the first of August, *A* would get the 1½ per cent dividend paid on August 15. If, however, *B* sold *A* a bond, (interest payable June 1 and December 1) *B* would ordinarily require *A* to pay two months' interest to cover the period during which *B* held the bond since the last interest date, June 1. The company would pay six months' interest on December 1 to *A* and thus *A*, in effect, would get interest for the last four months of the period.

Publicizing the declaration or "passing" of a dividend. A declaration of a dividend should be given full publicity in order that stockholders, investors generally, analysts, financial institutions, and others interested in financial news may know of the action taken. It is especially important that such publicity call attention to changes in dividend rates, whenever they occur. Sometimes the declaration of a dividend is published. Usually a notice is enclosed with the dividend check showing what the check represents, or the information is given on the check.

Any explanation of a change or declaration of a stock dividend is usually given in a letter to the stockholders. In the case of a stock dividend, such a notice should tell the stockholders (1) the purpose and effect of the stock dividend; (2) the amount of retained earnings capitalized per share; (3) the aggregate amount of retained earnings capitalized; (4) the capital accounts to which the aggregate amount has been charged and credited; (5) the percentage by which the stockholder's interest in the corporation before issuance of the stock dividend will be reduced if he should sell his dividend shares; (6) full particulars if the distribution is from capital surplus; and (7) the taxability of the stock dividend.

Any corporation concerned about maintaining good stockholder relations will also let the shareholders know why a regular dividend has been "passed," that is, not paid.

Research Question

(a) What percentage of earnings was paid out in dividends to the stockholders in the years 1937, 1942, 1947, 1952, and 1957 for the following companies: U. S. Steel, General Motors, General Electric.
(b) In general, why are not all of the earnings distributed?
(c) Is the retention of earnings by these companies likely to entail a penalty under Section 531 of the Internal Revenue Code?

Problem

Overtone Music Publishers, Inc., at the end of its second year furnishes the following financial statement to its stockholders:

Balance Sheet

Cash	$ 30,000	Accounts payable	$ 30,000
Accounts receivable	8,000	Notes payable	4,000
Inventory	40,000	Bonds	124,000
Land and building	200,000	Capital stock	130,000
Goodwill	40,000	Surplus	130,000
Organization	90,000		
Bond discount	10,000		
	$418,000		$418,000

Income Statement

Sales	$200,000
Cost of goods sold	100,000
Gross profit	$100,000
Selling and administration expenses	68,000
Interest	6,200
Depreciation	800
Amortization of bond discount	5,000
Net profit	$ 20,000

Mr. Jones, a director, advocates the declaration of a 15 per cent cash dividend on the stock. Mr. Smith, another director, suggests a 50 per cent stock dividend. Do you favor either plan? Why? If not, what would you advise?

CHAPTER 21

Expansion

Growth of corporations. Growth is the ordinary rule of life. Growth in business organizations is called expansion. Any established enterprise supplying a useful product or service at a fair price may reasonably expect, with sound management, to become larger as the nation grows and the market for the company's product or services becomes larger. Under ordinary circumstances a firm expands because (a) it can profitably dispose of more of its original line of products in existing markets, (b) it can capture a share of a new market for its established products, or (c) it can successfully make and sell new lines of products either by creating a market for them or by invading markets established by others.

Forms of permanent expansion. Expansion that results solely from gradual enlargement of the business and resources of the original company may be called *internal* expansion. In contrast to growth from within, a corporation may grow by acquiring ownership and control over other going concerns, or parts of such firms, and operating the original company and the formerly independent units as one organization. Expansion by this method may be called *external* expansion or expansion by combination. This type of expansion will be explained in the following chapters.

Direction of expansion. When a corporation acquires additional assets of the same nature in order to make and sell more of its original line of products, it expands in a *horizontal* direction. Similarly, a combination is said to be horizontal when two or more organizations engaged in the same or closely related lines or stages of production or distribution are brought together under one management. The American Tobacco Company was enlarged in this fashion.

When a company expands in order to engage in the production of articles or the furnishing of services essential to the manufacture or

distribution of its original line of products, and for which it was formerly dependent upon other firms, it is described as expanding *vertically*. For example, a distributing company may expand vertically by securing its own means to manufacture the article it sells; or a manufacturing company may develop its own distribution outlets and services instead of utilizing independent firms for this purpose. When two companies combine and the product of one of them is a necessary ingredient or component part of the product of the other, a *vertical combination* is formed. For example, a manufacturer of parts may combine with a company that is a supplier of the raw materials of the product it manufactures. Vertical expansion is a popular form, and many firms exist that have applied the principle to its logical and ultimate end. They own or control all of the primary production and distribution facilities, plus many incidental thereto, from extraction or raising of raw materials to the distribution and financing of sales to customers. The International Harvester Company is an excellent example of a company that grew by the process of reaching backward to control production of antecedent materials and forward to provide for sale of its products.

Sometimes a company undertakes to make products allied or supplementary to its original line of products, or, having its own outlets, becomes a distributor of such items for other manufacturers. This additional activity is known as *circular expansion*. The General Mills Corporation, for example, expanded in a circular direction when it went into the electric appliance field. Its customers for food products are logical customers for such appliances as it manufactures. When companies unite which make allied or supplementary, non-competing products that utilize the same distribution outlets, the result is a *circular combination*. The General Motors Corporation and the General Foods Corporation are examples of circular combinations.

Some companies grow bigger without a clearcut adherence to any of these directions. They are hybrids that possess the characteristics of any two or all three of the types of expansion described. Still others defy classification because of the haphazard and illogical manner in which unrelated activities and properties are brought under one control.

Motives inducing expansion. The primary economic motive that induces businessmen voluntarily to expand or combine their organizations is the desire to bolster, increase, or stabilize profits. Personal ambition of owners or managers for greater prestige and power plays a part, but usually this is an expected concomitant of financial gains. Undoubtedly many expansions, and especially combinations, resulted from an overpowering desire to influence profits by eliminating competition, but energetic opposition to those concentrating upon attainment

of such ends to the exclusion of all others has diminished interest in this objective as a motive for expansion. Growth today is the reward not for stifling competitors but for vigorously developing newer and better products. Under ordinary circumstances, promoters of well-conceived expansions expect to enlarge earnings by securing economies and reducing costs rather than by charging higher prices for products. As a matter of fact, many companies that have successfully expanded have passed on to consumers part of their savings in the form of lower prices and improved quality merchandise.

Limitations on expansion. Growth is desirable only so long as it is profitable. There are conditions under which it may not be profitable to expand. Manufacturers of products for which the demand is inelastic and already completely supplied would find difficulties in expansion unless they were willing to extend the horizon by branching out into new lines or by extending vertically. Those producers with limited access to raw materials or confined to certain market areas by prohibitive freight rates, in the absence of means to overcome these obstacles might find themselves in deep trouble if they attempted to enlarge. Thus the nature of the product or of the territory may impose limits beyond which a business cannot or should not go.

Size engenders extravagance and neglect of detail. Also, competent subordinates for responsible positions, capable of making executive decisions, are difficult to find. Of all the limits to expansion, managerial weakness is probably the most important. The extent to which expansion may be permitted thus depends on the elasticity of present personnel.

In any given locality or within any organization there exist slight rigidities, some inertia, and scarcities. If production is expanded to the point of diminishing returns, costs go up. Then adjustments of the factors of production or greater quantities of them are needed. But such factors are not always immediately available or procurable at a satisfactory price. Temporarily at least, there may be shortages of skilled labor, machinery, or suitable locations for factories, and the like. Under these circumstances expansion must be limited or deferred until the troubles can be surmounted and costs once again are brought into line through appropriate action by management.

Problems of expansion. Whether expansion from within or by combination is contemplated, planning and accomplishing it raise managerial, economic, social, and financial problems of considerable magnitude. Essentially all of these problems are managerial and they have been broken down into their several aspects merely to facilitate the discussion. In this chapter we shall deal briefly with the managerial, economic, and social aspects of expansion whether effected from within or by combinations. This will be followed by a discussion of the

financial aspects of expansion from within. The financing of external expansion will be treated in succeeding chapters, which are devoted to intercorporate relations and the methods by which combinations are effected.

Managerial aspects of expansion. Responsibility for determination of the profitableness of expansion and for making all other crucial decisions involved in the expansion program rests squarely upon the managers. The only test of the correctness of their judgment in the long run is the pragmatic one of greater net profits. By the time this test can be applied the corporation is usually too thoroughly committed to developing its plans to backtrack if the expansion proves to be a mistake.

The primary question to be answered in every case is whether or not expansion should be undertaken at all. Sometimes this decision is made under economic compulsion. Public utilities, very much in the same way as the railroads before them, have often been virtually forced to expand in order to meet the requirements of their franchises. They have been compelled to provide facilities for meeting the increased demand for their services in growing communities. Compulsion toward bigness may also become pressing upon a firm eager to maintain its competitive standing when principal rivals combine to get larger and aspire to positions of dominance. Management must then ascertain whether it can, and should, do the same in order to hold its relative place in the sun.

Practically always the psychological elements are in favor of expansion: lure of profit, pride of power, fear of competition, pre-emption of the field. These forces and the natural optimism of management of a successful enterprise in considering possibilities of growth must be curbed. Neither "rosy" interpretations nor convictions imbued with sentiment can be allowed to prevail over better judgment.

When management has affirmatively decided that permanent enlargement is desirable, there follows a host of complex problems. The expansion plan must be sound and well conceived. But this is not a simple matter since its foundation rests on shifting sands. It cannot be otherwise because planning and forecasting always involve assumptions about general economic conditions, and these may prove to be grossly inaccurate and misleading. Also, detailed and painstaking studies of advantages to be attained and obstacles to be overcome inevitably are based upon estimates and predictions. These may also prove fallacious in spite of every precaution and conservative analysis of data.

Frequently managements decide to undertake expansion, but it becomes necessary to pigeonhole the carefully worked out plans pending arrival of a more propitious time. If the business outlook is

uncertain, or other reasons intervene, plans must be deferred until management is satisfied that the time is ripe to make expenditures and incur obligations. In the period of rising construction costs and shortages of materials after World War II, many corporations temporarily shelved their plans, only to dust them off and proceed to carry them out about 1949–1950. At that time it became convincingly apparent that such costs were not only not likely to decline, but stood a good chance of going higher, with no end of the rise in sight.

When expansion is finally undertaken, the entire business must be reviewed in the light of existing and anticipated business conditions. Physical properties, equipment, and personnel situations must be examined. The market to be served must be thoroughly surveyed and forecasts prepared to minimize the risks of failure. Obviously, the exact nature of the problems confronting the architects of expansion will vary depending upon the direction of the expansion and whether it is to be developed through gradual additions of assets and personnel or consummated by combining with established enterprises.

Economic aspects of expansion. Economic problems permeate the entire subject of expansion, but we shall consider only a few of them. From the businessman's point of view, the most important question to determine is: What is the optimum size of the business? that is, how long and to what extent should growth be continued? Normally the answer is: As long as profits derived from the expansion are greater than the costs, and the rate of return on the investment does not fall. However, if a high rate of earnings is being realized, and the prospects for a satisfactory, even though somewhat lower rate of return, are good, expansion might well be justified. It is never a simple proposition to determine in advance—often not even with hindsight—how long expansion should be continued. Costs and economies are not attributable to one cause alone and there is no way to determine exactly what proportion of any gain derives from any particular clause. Increase in size and increase in profitability are not necessarily related.

Ordinarily one tends to think of large scale production, integration, and specialization as features associated only with large companies or with corporate growth. This is fallacious. Expansion may or may not provide realization of advantages of large scale production. Not all firms, even after growth, can take advantage of large scale possibilities. On the other hand, many units while relatively small and before expansion are already making full use of them. Of course, growth may enhance opportunities to benefit from large scale production. Similarly, gains derived from integration, specialization, and the like are not monopolies of big companies and should ordinarily not be considered benefits attributable to expansion. They may exist—and often do—in well-managed small organizations. In so far as growth by combination

is concerned, the possibilities of savings from integration and specialization probably should be considered as gains due to expansion. Frequently, a combination permits savings by (a) eliminating facilities and services that duplicate each other, and (b) by specializing plants and personnel in the activities or products for which they are best fitted. Before combination, such specialization may not have been possible.

Social aspects of expansion. When a corporation's expansion program is tending to bring the enterprise to a place of dominance in the field, the directors cannot overlook the question of the desirability of such growth from a social viewpoint. They must recognize that the two following points of view exist.

Many people justify expansion on the ground that large units are essential to economic operation. They realize that ours is a large enterprise economy with highly efficient use of our resources. Expansion by any one company, they feel, is merely a continuation of a pattern that has contributed to the economic development of our nation.

Other people consider that large units are socially dangerous. They believe that large companies infringe upon individual liberties in economic matters, and they question the desirability of further expansion or even of the continued existence of established enterprises in their present size. They hold that in spite of their stellar and yeoman service rendered in times of war, and the admitted benefits they have conferred in times of peace, giant corporations are a menace. They claim that "big business" encompasses so many activities, has a direct influence upon the lives of so many persons whom it employs, or to whom it pays dividends, and owns or controls so vast an amount of the national wealth that it impedes development of those it does not favor and may even constitute a threat to the state itself.

Difficulty of regulating size. Even if regulation of corporate size were socially desirable, practical difficulties would stand in the way of doing so, for no one has as yet found a formula that indicates beyond dispute when a corporation has reached a socially desirable size that should not be exceeded. The question, "How big is too big?" has no satisfactory answer and no sound principle of general application has been proposed that can withstand the withering cross-fire from critics and opponents. Industry naturally seeks to attain the most profitable size. Any basis for a rule limiting size, whether it be number of employees, amount of capital, percentage of total output produced, business done, or value of products, necessarily must be an arbitrary one. The application of such a rule may have the effect of limiting achievement, stagnating the normal processes of technological progress, and holding all firms to a level of mediocrity with consequent loss to our economy and detriment to our national security and world leadership.

Those who see no evil in bigness as such, yet recognize that as a

result of abuses of power accompanying bigness there may be evils, would rely upon the anti-trust laws and vigilance in enforcing them to prevent abuses. Others in this group would extend the doctrines of monopoly and restraint of trade to cover situations where dominance by one or a few corporations of a whole industry gives it or them the power to suppress competitors or engage in unfair tactics, whether or not that power is used. The subject of monopoly and restraint of trade will be treated more fully in the following chapter.

Concentration of business. One of the most disturbing features of corporate growth to those who hold that big corporations constitute a threat to equality of opportunity in a free enterprise economy is the related problem of concentration of productive facilities under the control of a single or a few corporations. This phenomenon appears in practically every field in which corporations exist. Public utilities and railroads show considerable concentration of assets, personnel, and other elements of size and power, but because of the nature of the services they render, such concentration is deemed necessary and desirable, and because these industries are under strict Federal regulation and supervision they give no cause for alarm. But as to the industrial field, there is much less tolerance. The reasons, of course, parallel those considered when we discussed corporate size and its implications. Those who see danger in the concentration of productive facilities in a few corporations allege that concentration creates obstacles to the formation of new small enterprises. They also maintain that where one or several corporations dominate an industry, dictation by example of the leader and co-operation of the principal followers are distinct possibilities. The opponents of concentration believe also that the future of such an industry tends to become too intimately attached to the success of the dominant company or companies and should they come into economic difficulties, stability of the entire economy may be jeopardized.

It has never been possible to prove conclusively that these fears are well founded. Concentration of productive facilities does not, in and of itself, constitute monopoly, and the phenomenon exists even in highly competitive industries. Vulnerability to attacks in the courts and operations in the limelight of public opinion in large measure have made leaders of industries cautious and careful to observe fair trade practices. There is no evidence that deviations from such practices are more prevalent in concentrated industries than in those of lesser concentration.

Complexities of the problem of concentration. The problem of concentration is perplexing because it is not well defined and the issues are not clearcut. The problems of size and of concentration are similar and connected, but not identical. The terms are both relative and

CONCENTRATION OF INDUSTRY [1]

Industry and Year		Value of Shipments (Thousands of Dollars)	Concentration Ratio: Per Cent of Value of Shipments Accounted for by—		
			4 Largest Companies	8 Largest Companies	20 Largest Companies
Cereal breakfast	1954	345,843	88	95	99+
foods	1947	284,320	79	91	98
Soap	1954	959,676	85	89	95
	1947	1,084,032	79	86	93
Cigarettes	1954	1,640,950	82	99+	100
	1947	1,131,891	90	99+	100
Tin cans and	1954	1,366,766	80	88	96
tinware	1947	678,924	78	86	94
Tires and tubes	1954	1,841,732	79	91	99
	1947	1,547,040	77	90	99
Motor vehicles	1954	6,111,479	75	80	87
and parts	1947	3,544,924	56	64	78
Tractors	1954	1,177,974	73	88	97
	1947	890,841	67	88	97
Distilled liquor	1954	711,313	64	79	93
	1947	870,235	75	86	95
Aircraft engines	1954	3,188,950	62	81	93
	1947	464,623	72	88	98
Steel works	1954	4,020,264	54	70	85
	1947	2,275,697	45	63	81
Motors and	1954	1,389,078	50	59	75
generators	1947	995,640	59	66	80
Meat packing	1954	1,394,486	39	51	60
plants	1947	977,144	41	54	63
Petroleum	1954	11,757,218	33	56	84
refining	1947	6,623,708	37	59	83
Woolen and	1954	890,281	27	38	55
worsted fabrics	1947	1,355,209	28	40	56
Beer and ale	1954	1,857,053	27	41	60
	1947	1,316,085	21	30	44
Radio, TV,	1954	2,130,207	24	35	53
and related products	1947	773,233	26	35	54
Newspapers	1954	3,091,027	18	24	34
	1947	1,891,252	21	26	36
Men's suits and	1954	1,140,731	11	18	31
coats	1947	1,412,782	9	15	26
Wood furniture	1954	1,113,264	8	13	21
	1947	898,674	7	11	19
Dresses	1954	1,455,080	4	7	12
	1947	1,359,030	3	5	9

[1] This table is based on Table 42 (pp. 196–219) of the Report cited in note 2.

variable depending upon the measurement used and the scope of the problem under consideration. From the standpoint of all corporations, a company may be huge, may control immense wealth, possess tremendous influence over thousands of workers, account for the produc-

tion and sale of a great quantity of an important product, and still, compared with other leading firms in that industry, may not exceed its competitors by an extraordinary amount. For example, the steel industry is made up of a number of gigantic corporations that control in the aggregate a far more substantial portion of the total national wealth than is devoted to manufacturing in many other industrial groups which show a higher percentage of concentration. It is more than probable that the second or third ranking steel company, which, of course, does not dominate its industry, controls far more assets and personnel than do some of the leading firms which do dominate other industrial groups. In some industries that are of minor importance when compared with steel, one firm, large compared with its competitors but small relative to the general run of corporations, may represent a high degree of concentration. In the first instance we are dealing with a giant among giants and in the second with a giant among pigmies.

Concentration must be examined in the light of the nature of the industry concerned. For example, in the automotive field, corporations must necessarily control large resources and conduct large scale operations or their products would be too costly for common and general use. On the other hand, there would not appear to be any justification for concentration of great assets in the biscuit and cracker industry.

One of the most authoritative recent studies of concentration is contained in the report of the Antitrust and Monopoly Subcommittee of the Senate Judiciary Committee [2] compiled in 1957 from figures supplied by the Bureau of the Census. As the table at page 426 indicates, the basic factor used in measuring concentration is the proportion of the total value of shipments in an industry accounted for by the 4, 8, and 20 largest companies in each industry. The figures used are taken from the 1954 and 1947 Census of Manufacturers. The table reflects the degree of concentration in 20 selected industries, arranged in order of concentration. These figures indicate that those who would attack the problem of concentration must concern themselves with *relative* size and degree of dominance as well as with absolute corporate size, as separate concepts, if they would find an equitable solution.

Aid to small business, a remedy. The theory exists that if small firms can be encouraged to remain independent, and competitively competent to withstand efforts of larger firms to capture the markets they serve, corporate concentration will be checked. We discussed the problem of supplying small businesses with capital for new enterprises in the chapter on promotion, at page 205. The Small Business Administration provides capital not only for new enterprises but for small

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2 "Concentration in American Industry," Report of Subcommittee on Antitrust and Monopoly to the Committee on the Judiciary, United States Senate (Pursuant to S. Res. 57—85th Cong.), July 12, 1957.

established entrepreneurs to enable them to grow and to prevent their elimination or absorption by stronger rivals, particularly big firms. As previously pointed out, the SBA, under authority of the Small Business Investment Act of 1958, also provides funds for small business investment companies, which, in turn, help finance small corporations by purchasing their convertible debentures.

In response to the clamor for a tax adjustment for small businesses, the Small Business Tax Revision Act of 1958 was passed. This act, despite its name, actually provides important tax savings for all businesses, large or small. It provides an *additional* depreciation allowance on tangible personal property, except buildings, in the year acquired. The allowance, for each taxpayer, is 20 per cent of the first $10,000 of cost, $20,000 if husband and wife file a joint return. Since most businesses buy such things as machinery, fixtures, and equipment each year, the benefit can be repeated annually. The law also allows a fully deductible loss, instead of a limited capital loss, on the sale of stock in a "small business corporation" if certain qualifications are met.

Much emphasis is currently placed on the managerial shortcomings of small businessmen. According to one report 89.4 per cent of the business failures in 1953 were attributable to managerial inadequacies.[3] Another study disclosed that 91.3 per cent of the 12,686 business failures in 1956 were due to such causes as lack of experience in the line, lack of managerial experience, unbalanced experience, or incompetence.[4] The need to make education in the skills of business management available to all is recognized. In 1957, the SBA co-sponsored approximately 160 small business courses at over 70 colleges. However, the schools have little idea of how best to accomplish the goals of the program, and as a result the SBA has to plan the curriculum.[5] In time, it is to be assumed, the colleges will learn enough about the problem so as to be able to plan a course schedule more closely suited to the needs of the community and the abilities of the students. Following the example set by the SBA, many trade associations are scheduling small business seminars and sponsoring other educational programs for their members.

Financial aspects of expansion. In Chapter 9 we took up the subject of capitalization and in later chapters we shall devote attention to some of the financial problems peculiar to certain forms of combinations. Here we must make a few pertinent observations on financing expansion in general before we treat the major questions that must be solved in financing internal expansion.

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[3] "Whither Small Business?" by Paul Donham, *Harvard Business Review*, March-April 1957, p. 75.

[4] Dun & Bradstreet, Inc., *The Failure Record Through June 1957*.

[5] Donham, *op. cit.*, p. 76.

Most expansion takes place in a spirit of optimism during the prosperity phase of the business cycle. If expansion programs are badly financed or the firms have failed to put their houses in order prior to embarking upon a program of growth, expected gains may not materialize. Overcapitalizations and weak financial structures may bring disaster before corrective measures can be instituted.

As a rule, companies contemplating expansion attempt to adjust their policies well ahead of time to conserve their working capital and retain profits. They seek to remain flexible so that if it becomes necessary to go outside for money they can obtain it on the best possible terms from the most likely sources at the time of need. Management is hardly ever free to select the "ideal" means of getting cash, but must act as circumstances dictate.

Three major financial questions must be solved: (1) What amount of funds is required? (2) What are the sources for obtaining it? (3) When shall they be procured?

Determining the amount of funds required. In general, the amount of funds required is measured in the same way as has been described for the promotion of a new enterprise. Usually, forecasts are made of capital expenditures required to carry out the program, and long-term estimates are made of profit and loss and cash receipts and disbursements. The financial planning usually involves the co-ordination of every department and section of the enterprise.

Sources of funds for expansion. Since fundamentally a business is run for the benefit of its owners, management must attempt to raise capital by means that will enhance profits most and keep down the annual costs. Other objectives are to avoid dilution of the equity or the compromise of the control of stockholders. Indentures of outstanding bonds and covenants attaching to preferred stock must not be breached, nor creditors placed at any disadvantage. With these considerations in mind, management should attempt to keep the best security until last for emergency "rainy-day" financing, without embarrassment or necessity to imperil soundness of the capital structure.

Considered broadly, there are two principal sources of funds for expansion: (1) *internal sources*—earnings retained by the business in the form of depreciation and other reserves, and income left over after all expenses and reserves, and not distributed to the owners of the business, and (2) *external sources*—funds derived from loans and the sale of securities.

Financing out of earnings. In the last three decades there has been a strong and ever more prevalent tendency toward financing expansions from internal sources. In the post-depression period, 1933 to mid-1937, the capital markets supplied a negligible amount of new funds, and companies in need of funds for modernization and replace-

ment of fixed assets were practically compelled to dip into their accumulated earnings and even to use funds normally considered as working capital. According to a 1956 Department of Commerce survey, in 1955 corporations plowed back earnings into their businesses amounting to $8.8 billions (including depletion allowances) of undivided profits after taxes and $14.8 additional billions from depreciation allowances. Depreciation allowances are generally applied to replacements of machinery and equipment. Since World War II, corporations have been able to accumulate enormous sums in cash, and because of unusually high earnings have found it possible to pay their customary dividends and still retain great sums for use in the business.

Since expansion money is "venture" capital, employment of the firm's own funds is a soundly conservative means of financing expansion. However, stockholders who fail to see high earnings reflected in increased dividends often complain about retention of funds even though they stand to benefit when the markets reflect the improved status of the company in higher security prices.[6] Investment bankers claim that lack of adequate dividends in relation to earnings can account for poor market performance of industrial stocks. This in turn makes management reluctant to resort to the securities market for equity capital needs.

External sources of funds. If a corporation cannot finance its expansion from accumulated earnings and surplus, it may tap any of the following sources: (1) the owners of the business, (2) savings of investors obtained through sale of securities, (3) term loans from banks, (4) loans from customers, (5) sale of unnecessary assets, and (6) institutional financing of buildings to be acquired or already owned, including the sale and leaseback arrangement. Some of these sources have been treated fully in other parts of this text and so will be covered briefly here. Others will be explained more fully in the following pages.

Equity capital from owners. A closely held corporation may procure funds from the sources of the original capital, namely, the owners. However, large corporations with widely held stock find it more difficult to draw upon the thousands of stockholders for additional money. They may, as was explained in Chapter 13, issue rights to old holders to purchase additional shares in proportion to their holdings of record and utilize investment bankers and the capital markets to absorb any shares not taken up by the old stockholders.

Funds from the capital market. Access to the capital markets is always available to sound business enterprises. However, the desir-

[6] See page 188.

ability of seeking funds from investors through the securities markets depends upon the receptivity of the markets for the type of security the corporation proposes to sell when the financing is required. The influence of market conditions on new issues was discussed fully at page 181.

Just as there are times to go to the public for funds and other times when the capital markets should be avoided, there are times when stock should be sold and other times when only bonds provide the most desirable vehicle for fund-raising. In a roaring bull market for stocks, like that of the late twenties, it is possible for corporations to dispose of equity securities in large volume at excellent prices. In periods of "easy" money—especially when government policy fosters and encourages this condition by actions to maintain it—borrowing through debt securities becomes most attractive.

In any event, recourse to the capital market, except in the case of private placements, means engaging the services of investment bankers and complying with the Securities and Exchange Commission rules and regulations, and perhaps exchange regulations and requirements. It involves risking an unforeseen change in the market during the months of preparation before issuance, which may make any sale impractical just at the time when funds are most needed.

Term loans. Commercial banks traditionally are suppliers of funds required for working capital purposes and not for permanent capital. In the past two decades, however, they, as well as life insurance companies, have played a part in lending money for expansion of plants by making term loans.

Definition. A term loan is one with a maturity usually of not less than two and not more than ten years, repayable in installments. Before term loans came into common use, the practice was for businessmen to borrow on short-term notes. The notes were often renewed again and again, and payment frequently was not made until several years later. Term loans thus are simply a frank recognition of this condition. They meet the need for filling the gap between lines of credit and invested capital.

Form. The conditions of the term loan are set forth in a formal agreement between the bank and the borrower. Usually the borrower gives the lender a series of notes of different maturities, the first note to mature within six months and subsequent notes to mature at intervals of six months until the entire loan is paid. Some loans are scheduled with small initial payments followed by gradually increasing payments as the loans near maturity. A loan partially amortized during its life, with the major portion due upon the final payment, is considered to have a "balloon" feature. This feature is especially suitable for term loans made for expansion purposes because the new under-

taking cannot be expected to return profits, or even the cost, immediately. Nearly all term loans have acceleration clauses to permit the immediate calling of the loan by the lender, should any of the conditions be violated or a default occur, or the borrower become insolvent or bankrupt.

Interest. Interest rates show a wide range, from as low as 1 per cent to as high as 8 per cent. The standing of the borrower and the condition of the business are major factors in determining the interest rate. Sometimes the rate is scaled upward as the maturities lengthen. Although security is not a requisite of a term loan, a business with good collateral will readily use it to secure better terms. Among the types of collateral offered are stocks, bonds, chattel mortgages, life insurance on lives of officers of the company, guarantee by an individual, or pledge of inventory or accounts receivable.

Conditions and restrictions. The lender includes provisions in the agreement to make certain that the character of the business will not change. The provisions may relate to maintenance of working capital position, maintenance of property in good condition, keeping a required amount of insurance in force, and rendering financial statements at fixed intervals (usually monthly or quarterly, more rarely semi-annually). Similarly, restrictive conditions are often included. These include prohibitions against other borrowing, merger or consolidation with any other business, sale of assets other than in the usual course of business, pledge of assets, payment of excessive dividends and/or management bonuses, too rapid expansion, and extensions of credit other than in the usual course of business. Naturally, few term-loan notes are supported by agreements requiring all of the obligations and restrictions mentioned.

Uses of term loans. Term loans are used for a number of purposes other than expansion. They have been used for refinancing corporate mortgages or mortgage bonds. The term loan offers the borrower both the amortization privilege and the additional advantage of a more favorable interest rate. They have also been used for refinancing stock issues. For example, many corporations have used term loans to retire preferred stocks. As pointed out in Chapter 16, term loans are also used to augment working capital. When a business foresees the need of additional funds it may negotiate a term loan to be available under certain contingencies or at a predetermined time. The loan and its agreement do not become operative until the stated time arrives or unless the stated event occurs. This arrangement is called a *standby credit.*

An interesting example that illustrates the way in which term loans are utilized is furnished by the Armco Steel Corporation. In anticipation of heavy capital expenditures to be undertaken in the years 1955–60, the company arranged a standby credit of $100,000,000

with a group of banks. The first credit agreement was dated September 1, 1955, and was for $50,000,000. The contract provided that the portion of the sum actually used would carry interest equal to the lowest prime rate for short-term commercial loans in effect on the date of the borrowing at any of the banks participating in the credit, but which in no event would be lower than 2¾ per cent nor higher than 3¼ per cent. On December 31, 1957, any amounts then outstanding would be converted into term loans represented by notes payable in installments of three-tenths on December 31, 1962, three-tenths on December 31, 1963, and four-tenths on December 31, 1964. Such term loans would bear interest at the rate of 3¼ per cent on the unpaid principal. Armco must pay a commitment fee of ¼ per cent on any unused sums. A second credit agreement for $50,000,000, with the same group of banks, was dated November 1, 1956, and the interest rate for sums actually used was the same as provided for in the first contract except that there was no minimum or maximum. Any amounts outstanding on December 31, 1958, would be converted into term loans represented by notes payable in five equal installments beginning on December 31, 1959, which would bear interest at the rate of 4½ per cent. The commitment fee was ½ per cent per annum. Mr. F. E. Danford, the Treasurer of Armco Steel, explained the basis of these credit agreements as follows:

> We negotiated these credit and term loan agreements primarily as "insurance" in connection with the rather sizable capital expenditure program we had adopted for the years 1955 through 1960. Our forecasts indicated we could probably finance this capital expenditure program without additional financing, but we felt that in the event a temporary recession in business or narrowing of profit margins some time during the five-year period resulted in earnings below those indicated in our forecasts we should have some outside funds on call to make up the slack and tide us over. Usually sizable capital expenditures in our industry must be planned a considerable time in advance and commitments made accordingly, and thus such expenditures cannot be shut off quickly in the event of a temporary down-turn in the pace of business.

Borrowing from customers. Small corporations occasionally are able to secure financial assistance from large corporate customers with excess cash, who purchase the bulk of the production of the small firm that wants to expand. If benefits will accrue to the principal customer from the expansion, the customer may be willing to offer such assistance. However, in most cases the small, sheltered company is so dependent upon the large one as virtually to constitute a subsidiary without the legal relationship to effectuate that status.

An unusual example of borrowing from a customer occurred in 1950 when Jones & Laughlin Steel Corporation obtained a loan of

$28,000,000 at 3 per cent interest from General Motors Corporation to help expand the steel company's capacity. The financing was a two-way boon. The steel company got much-needed capital[7] and the motors company received assurance of 50,000 tons of steel a year under the agreement. The arrangement provides for repayment of the loan in monthly installments of not more than $325,000, the entire debt to be paid off by 1966. Part of the payment can be made with products rather than cash.

Sale of unnecessary assets. Unprofitable or unused assets not held in reserve for any good reason should be sold whether the company needs the money or not. Such cash can be invested or used to promote some profitable end. An example of the use of sale of assets to furnish money for a more productive use occurred in the case of International Breweries, Inc., in 1956. The company sold the plant and equipment at the very old and uneconomical brewery, where its "Frankenmuth" brand was brewed, for a sum in excess of $3,000,000. This money, plus additional funds from undistributed earnings, was used to purchase 88 per cent of the outstanding capital stock of Southern Brewing Company ("Silver Bar"), and all the stock of the Krantz Brewing Company ("Old Dutch"). The purchase enabled International Breweries to obtain a foothold in the southern market, as well as to acquire two modern breweries.

Institutional financing of construction with lease arrangement. An industrial company in need of funds to finance the acquisition of buildings, plants or laboratories may find a large insurance company or a tax-exempt institution, like a university or charitable institution, ready to finance the construction of the required property and to make the building available to the corporation under a lease arrangement. The financing procedure is as follows: The financing institution provides the money to construct the desired building. It retains title and leases the property to the industrial company for a period of twenty to thirty years. The tenant usually covenants to maintain the physical plant, to pay insurance and taxes, and to assume practically every other obligation customarily incident to and associated with ownership. The lessor receives from the lessee an annual sum sufficiently large to amortize the cost of the property during the term of the initial lease plus a "satisfactory" income on its investment. Very often the lease contract provides for renewal of the lease at a much lower, or even a nominal rental, once the property has been amortized.

This method of financing expansion is an innovation in finance

[7] The company had already raised funds through bank credit and a commitment for debentures to finance its expansion program. It might indeed have encountered difficulty in raising more funds at a favorable rate if the General Motors Corporation had not become interested in the deal.

that became popular in the post-World War II expansion period. It has appeal for companies of good financial standing that do not wish to tie up their funds in fixed assets. The building to be acquired must be suitable for general use and well located to interest the institutional investor, because if the lessee defaults on its payments, the financing institution must be in a position to rent the building to another company. Stores and office buildings have been the principal types of structures financed by this means.

Institutional investors find this financing and lease device useful and desirable because it provides another outlet for their funds at reasonable rates of return. Furthermore, they are relieved of the principal duties of property administration and maintenance although they have the legal title. In the event of default or bankruptcy of the tenant corporation, they need not await reorganization to determine salvageable sums, but may dispossess the tenant, sue it for back rentals and damages, and rent the properties to another going concern.

Industrial lessees use the device because it provides a simple means of obtaining funds without increasing bonded indebtedness and assuming all the covenants and restrictions entailed in a bond indenture. Furthermore, if the industrial company were to finance the acquisition of the building through the usual mortgage loan, it would be able to raise not more than about two-thirds of the value of the property whereas under the financing plan described the institutional investor furnishes the full amount of funds needed for the construction of the building. Another advantage to the industrial company is that its financial statement reflects no heavy investment in a fixed asset and no long-term debt. However, so far as the company's borrowing capacity is concerned, lenders generally would regard the lease arrangement as the equivalent of debt financing and would probably consider the capitalized value of the lease rental the amount of indebtedness represented by the lease financing. Another point in favor of this type of financing is that by means of adjustments in annual rentals, the cost of the plant can, if necessary and concurred in by the owner, be realistically charged against current earnings. From the tax standpoint, the amortization charges and annual rent payments are deductible as operating expenses whereas, if the same amount of money were obtained by loans, only the interest thereon would be deductible.

Sale and leaseback financing. The post-World War II years also saw the increasing use of the sale and leaseback to acquire additional working capital that might be used for expansion. Many firms owned property acquired during years when the price of construction and the dollar value of real estate were far below what they are now. Thus, for tax purposes, the property had a low "basis" and the annual deduction

for depreciation was measured by this low cost basis. As a result, replacement costs for obsolete and worn-out equipment will greatly exceed any reserve for depreciation which has been accumulated. A sale and leaseback arrangement, under which the corporation sells the property to an institutional investor and then leases it back results in (1) an immediate lump-sum increase in working capital represented by the proceeds of the sale (less the capital gains tax payable on the profit, and (2) substitution of a rental deduction higher than the depreciation deduction previously available.

Here is an example of such a transaction: The Jones Co. owns a plant with a present market value of $2,000,000 with a basis for depreciable property of $100,000 and a basis for land of $200,000. With an estimated remaining life of 20 years for the plant, Jones Co. is allowed depreciation of $5,000 a year. Jones Co. now sells the plant and land for $2,000,000 and signs a lease for 20 years agreeing to pay $150,000 in rent a year. Jones Co. has a gain of $1,700,000 ($2,000,000 sales price less $300,000 basis) upon which it must pay a tax, at 25 per cent, of $425,000. Jones Co. thus has an immediate lump-sum increase in working capital of $1,575,000 for expansion ($2,000,000 sales price less the tax). Then the company pays an annual rent of $150,000, but this is deductible so that the net annual cost (considering a tax saving at 50 per cent) is only $75,000 a year.

The sale and leaseback may also be used to enable a corporation to take a loss on property that has gone down in value. At the same time the company will increase its working capital. If, in the example above, the basis of the property had been $3,000,000, the sale for $2,000,000 would result in a loss of $1,000,000. This loss is fully deductible from the corporation's income and so will result in a tax saving of about $500,000. The increase in working capital would be $2,500,000 (sales proceeds plus tax saving). The rent payment would still be a deduction each year. However, if the leaseback is for 30 years or more, or if an option is granted the lessee to repurchase, the company may lose its tax deduction.

Before the enactment of the Internal Revenue Code of 1954 it was common to make sale and leaseback arrangements with tax-free organizations, such as colleges and charitable institutions, since these organizations did not have to pay tax on the rent they received. However, the 1954 Code (Sec. 514) provides that tax-exempt institutions (except churches) have to pay tax on part of the rents collected if the institution borrowed money to acquire the property and part of that loan is still outstanding.

Although, as indicated above, sale and leaseback financing has certain advantages, its disadvantages must also be considered. The corporation will have a fixed charge (rent) which must be met regu-

larly just as if it had long-term debt outstanding. Such a charge may become especially burdensome in a period of deflation. Furthermore, a lease arrangement is less flexible than a bond issue which might be refunded at a lower rate of interest in such a period. Finally, the cost of the leaseback may be higher than other methods of financing. Corporations may be able to borrow more cheaply on a long-term basis than the return required by financial institutions in a sale and leaseback arrangement.

Timing the procurement of funds. Having covered the questions of determining the amount of funds required for expansion and the sources of funds, there remains only the question of timing the fund procurement to be considered. Axiomatically, the best time to obtain funds is when the company can do so, and not when it must. Paradoxically, the time to build is in a period of depressed business activity when materials and labor are cheapest, but the best time to obtain money is in a period of high prices and boom. In practice, businessmen can rarely take advantage of the theoretically perfect plan. They would have to be extremely lucky or something more than clairvoyant to hit it right. What they actually do is to raise money in whatever practical manner they can at the time of need or a short time before, with reasonable deferments if they anticipate changes to their advantage within a short time. Sometimes they procure cash in two or more steps, using temporary expedients such as term loans and subsequently refinancing with stocks or bonds at the first opportunity.

Research Questions

1. Using Moody's, Standard & Poor's, or the annual statements of any large company, analyze the expansion of the corporation over the periods 1943–47, 1948–52, and 1953–57, noting particularly:
   (a) What assets increased.
   (b) How these increases were financed.
   (c) What rate of return the company made on its investment.
2. From the reports of the Securities and Exchange Commission, or any other source, prepare a table showing how current assets and liabilities of all manufacturing corporations increased in the period 1946–56. From what sources did corporations generally get their funds for expansion in 1956?

Problem

Static Corporation, a manufacturer of electrical machinery, needs a new plant. It cannot finance the building from its own earnings and surplus. The following methods of financing have been proposed: (1) A mortgage on the new plant. (2) A sale of bonds. (3) Asking an insurance company to build the plant and then lease it to Static Corporation. (4) Selling Static Corporation's present office building to the insurance company, with a leaseback arrangement, and using the proceeds from the sale to build the plant.

(a) Which method would you advise and why?
(b) Can you suggest any other methods?

CHAPTER 22

Intercorporate Relations

Scope of chapter. In the preceding chapter we discussed the principles applicable to expansion, whether it is effected by the internal or external method, and treated the financing of internal expansion. To prepare the student for the chapters that follow, which are devoted to expansion through consolidation, merger, sale of assets, lease, and holding companies, we shall treat in this chapter the general subject of intercorporate relations. We shall first consider briefly the methods whereby two or more companies join to become one, or otherwise associate themselves in whole or in part for a business purpose and under a common policy. Then we shall give an explanation of certain legal doctrines that are pertinent to a study of combinations. This will be followed by a brief historical study of the development of combinations, which will include an account of the legislative controls that were introduced from time to time. The student will thus see the influence of legislation on expansion through intercorporate relations in this country.

Forms of intercorporate relations. The relationships of greatest interest may be divided into two groups: (1) those formerly employed and now obsolete, although still worthy of notice as antecedents of certain relationships that developed later; and (2) those currently in use. In the first group are relationships based upon agreements, both informal ones called "gentlemen's agreements," and formal ones called pools and trusts. In the second group are consolidations, mergers, combinations achieved through the sales of assets and leases, joint subsidiaries and joint ventures, holding companies, communities of interest, and trade associations. Of this second group, two relationships, namely communities of interest and trade associations, constitute nothing more than co-operative arrangements of firms under separate man-

agements to work together. The others of this group are actual unions or combinations of property under one management by means of contracts, memberships, or transfers of title.

The survival and extent of the use of each of the forms has depended more upon the legality of the form of combination and the lawfulness of the uses to which it has been put than upon consideration of its economic merit for proper business ends. Generally speaking, each of the forms is or was more or less well suited, from an economic standpoint, to accomplish any *legitimate* ends intended by its adoption. However, a few of them failed because the legal relationships, that is, the forms of combination, attempted were inconsistent with common or statutory law principles and could not be sustained. Others failed because the ends they sought to achieve and the methods they utilized were legally objectionable, even though the form of combination was unassailable.

The informal, or "gentlemen's agreement." This was the most tenuous of the forms of intercorporate relations. It is now defunct. It was founded upon a mere "understanding"—usually oral and confidential—between those in control of the participating companies that the companies would act pursuant to a common policy to accomplish certain objectives. The usual purpose of the agreement was to divide markets, place limitations on production, maintain or fix prices, or similarly restrain competition. Since agreements to restrain trade or create a monopoly are considered contrary to public policy and unenforceable, any party to an agreement could, at any time, refuse to adhere to it. The other parties were left without a remedy since the courts would not compel compliance.

The pool. The pool, one of the earliest intercorporate relationships, but now obsolete, was a formal association of firms to achieve more or less the same ends as the gentlemen's agreement. It was customarily, although not necessarily, reduced to writing and often was confidential in whole or part. Like the gentlemen's agreement, it was unenforceable because the ends it sought were condemned on the grounds of public policy. It was also unstable, since any member could withdraw at will without penalty. Its inadequacies induced businessmen to seek a more binding and legally acceptable relationship. The trust device was believed to be the solution.

The trust. The basis of the trust structure was the voting trust agreement (see page 65). In accordance with this formal document, stockholders of combining companies transferred to trustees all or a sufficient number of their respective voting shares to assure control in the trustees. In exchange, they received trust certificates of limited negotiability. The trustees then voted the stock of the various corporations in the interests of the entire group. Profits were placed in a common

fund out of which distribution was made to the holders of trust certificates.

Shortly after the trust was adapted as a form of business combination, the device was subjected to careful scrutiny by the courts. Two decisions showed corporate lawyers that the trust form of organization was no less vulnerable from a legal standpoint than the pool had been.[1] It was the trust device also that aroused public indignation and gave rise to "anti-trust" legislation (see pages 446 *et seq*).

Holding companies. The use of the holding company was facilitated, and possibly suggested, by the fact that New Jersey enacted a statute which authorized corporations to hold capital stock in other corporations. A holding company, which we shall discuss more fully in a later chapter, creates a relationship between business entities through stock ownership of one corporation by another corporation. The latter then undertakes to determine policies and control the affairs of the subordinate company. The device is economically sound and one that corporations may legally employ. It has at times been put to uses contrary to the public interest and the courts have condemned some holding companies on the ground that their activities were unlawful and objectionable. However, they have not failed to uphold the legality of the relationship itself.

Community of interest. One of the oldest relationships to effectuate concerted action among corporations is the community of interest. This appears whenever otherwise unaffiliated companies, without necessity for specific agreements of any kind, are directed pursuant to a common policy, and work together towards a common end. This is usually achieved through ownership of stock in the several companies by one person or by a group which is bound together by common interest or family relationship. When used to restrain trade or for monopolistic purposes, it will run afoul the anti-trust laws.

The most tangible form in which the community of interest manifests itself is the interlocking directorate. This is a method of control whereby directors who represent the management of each of the companies are elected to the board of directors of the other company. Through these persons the will of the common dominant stockholders is executed.

The law does not look with much favor upon interlocking directorates. Contracts made between two corporations having common boards of directors will be given careful scrutiny by the courts and may be declared void if the transaction involved unfairness, unreasonableness, or fraud. Legislative restrictions have also been placed on

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[1] The two decisions referred to above are People v. North River Sugar Refining Co., (1890) 121 N. Y. 582, 24 N. E. 834, and State v. Standard Oil Co., (1892) 49 Ohio State 137, 30 N. E. 279.

interlocking directorates. Section 8 of the Clayton Act (see page 451) makes it unlawful for a person to hold directorships in two or more competing corporations if the corporations are engaged in interstate commerce and one of them has capital, surplus, and undivided profits of more than $1,000,000 and *if* elimination of competition by agreement between the corporations, would constitute a violation of the anti-trust laws. The courts have had little chance to interpret this section since the Federal Trade Commission has dismissed all the complaints it brought under this section while the Justice Department waited almost 40 years before initiating any action under it.[2] However, the section has had some effect since many persons holding interlocking directorships have been persuaded to resign from all but one of their directorships without formal action being instituted.[3] The use of the interlocking directorate device may have been further discouraged by a decision that *stockholders* may sue to force the director's resignation from one of the competing companies.[4]

Other legislation has restricted the use of interlocking directorates in specific industries.[5] But the interlocking directorate has not yet become obsolete. For one thing, the laws generally apply only to competing corporations and therefore not to corporations in a buyer-seller relationship, although such interlocks often have the effect of eliminating competition. Further, the same purpose can often be accomplished by having an *officer* of one corporation serve as a *director* of another without violating the technical prohibition against being a director in both corporations.

Consolidations, mergers, sales and leases of assets. These forms of intercorporate relations have often been used because of their excellence. In addition to the holding company form, these are the most satisfactory means of unifying business under one control. In the following chapters they will be discussed at length, but it is necessary that they be defined at this point.

A complete union of two or more companies into one new company is called a *consolidation*. The uniting corporations are voluntarily extinguished according to a plan approved by the stockholders and the

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[2] U. S. v. W. T. Grant Co., (1953) 345 U. S. 629, 73 S. Ct 894; U. S. v. Sears, Roebuck & Co., (1953) 111 F. Supp. 614.

[3] Victor H. Kramer, "Interlocking Directorships and the Clayton Act After 35 Years," 59 *Yale Law Journal* 1266 (1950).

[4] Schechtman v. Wolfson, (1957) 244 F (2d) 537.

[5] For example, the Public Utility Holding Company Act prohibits registered companies and their subsidiaries from having as an officer or director any person who directly or indirectly represents a bank that holds a majority of the stock of the corporations concerned. Similarly, the Interstate Commerce Act prohibits interlocking directorates among railroads except with the authorization of the Interstate Commerce Commission. The Clayton Act also restricts interlocking directorates among banking corporations and between railroads and their suppliers.

new entity takes over all of their properties, liabilities, and non-dissenting stockholders remaining upon execution of the plan.

When one or more corporations are fused into one already in existence, the result is called a *merger*. Upon the agreement of merger becoming effective, after approval by the stockholders, the separate existence of the company acquired ceases and the acquiring corporation succeeds to all the rights and property of the corporation acquired and becomes subject to all of its debts, liabilities and duties.

The distinction between the consolidation and merger may be of importance in such matters as the procedures provided by statutes for bringing them about, tax and accounting questions, jurisdiction of the courts, and special statutory privileges and exemptions. It may also be important to creditors who seek satisfaction of unpaid claims against constituent companies. In popular parlance, however, the words consolidation and merger are used interchangeably. Careful students should nevertheless observe the distinction, though in fact in this country the difference between merger and consolidation, as far as the result is concerned, is merely a question of whether a new corporate name is used or whether one of the old corporations continues to use its name in the operation of the expanded business.

A combination brought about by *sale of assets* of one company to another is also referred to as a merger when it results in the integration of all of the assets of the selling company into the buying corporation. In that case the selling company usually ends its independent existence and loses its identity. If only part of the assets are sold, such as, for example, one department of the business, then only that part is integrated with the buyer's company and the selling corporation may continue its activities with the assets that it has retained. This would not be termed a merger, but a purchase and sale.

One company may secure beneficial use and control over the assets of another, without affecting ownership, by means of a *lease of assets*. This is a short- or long-term contractual arrangement between the owning corporation, called the lessor, and the company intending to make use of the property, called the lessee. The former retains the title to the assets and receives rent in return for relinquishing rights to their use.

Joint subsidiaries and joint ventures. For a variety of reasons corporations may wish to cooperate without forming a permanent union or giving up the use of a substantial part of their assets. A corporation may wish to enter a new field but finds its capital resources limited. Or it may wish to conduct a research and development program beyond its financial means. It may be able to do these things if it cooperates with one or more other corporations in the formation of a *joint subsidiary* or if it enters a contractual arrangement known as a *joint venture.*

A joint subsidiary is formed when a separate company is incorporated by two or more existing corporations. All the stock of the joint subsidiary is owned by the "parent" corporations. The parent corporations thus remain separate entities risking only a relatively small amount of their capital in their cooperative effort. The subsidiaries are sometimes referred to as "50-50 companies." This is often a misnomer because most joint subsidiaries today are owned by more than two companies or by two parent companies in unequal proportions; e.g., one corporation may own 70 per cent of the subsidiary's stock, the other owning 30 per cent. According to a recent survey, more than half of the 345 known joint subsidiaries in the United States were in two industries, oil and steel, where they were organized primarily for research and development of new processes and products.

Although a joint subsidiary is often well suited for the purpose for which it was formed, it may become unwieldy if too many "parents" have to be consulted before the "child" can act. Divided control can result in dissention and make decisions difficult.[6]

The formation of a joint subsidiary creates a permanent entity, namely, another corporation. This may not always be desirable; the cooperation of a number of companies may be needed for only a relatively short amount of time. In that case, the *joint venture* may be more advantageous. This is an agreement for a specific period of time, or for the duration of a given project, and thus does not tie up capital permanently. One corporation usually acts as the "sponsoring company" of the project; it holds the major interest and invites others to participate on a fixed percentage basis. Profits are then drawn in proportion to the percentage invested. After the project is completed, the equipment is sold and the proceeds are disbursed. Such arrangements are found most frequently in the insurance and construction industries. For example, the building of the Grand Coulee Dam and the San Francisco-Oakland Bay Bridge were projects undertaken by joint ventures linking a number of small and large firms.[7]

Trade associations. A trade association is an association of business organizations in a common field, formed for the purpose of promoting

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[6] See Abercrombie v. Davies, (Del. Sup. Ct., 1957) 130 A.(2d) 338, involving the American Independent Oil Co. which had been formed by eight corporations and two individuals. An elaborate voting agreement among six of these stockholders, owning about 55 per cent of the stock, to prevent the largest single stockholder, owning about 33 per cent of the stock, from acquiring control, was struck down as an illegal voting trust.

[7] Whereas individuals can do business together through a corporation, a joint venture, or a partnership, only the first two methods are open to corporations, i.e., the joint subsidiary which is a corporation with corporate stockholders, and the joint venture (see page 22). In most states, corporations cannot enter into partnerships with each other or with individuals. Although joint ventures and subsidiaries may be formed without violating the anti-trust laws, they may run afoul these laws if used as instruments of monopolization or for the elimination of competition.

their mutual interests and establishing industry standards. The trade associations concern themselves with such matters as proposals for standardizing accounting methods, credit policies, problems in labor relations, public relations, collection and dissemination of business facts, trade promotion, market and technical research, and related activities. In recent years they have been active in influencing legislation relating to the interests of the groups they represent.

Trade associations are essentially different from the other forms of intercorporate relations we have considered in that they provide for cooperation in matters ancillary to the main businesses of the members. In all of the other forms, the businesses actually unite in their primary activities and the desired end is of immediate and direct importance because of the effect upon production, prices, and distribution.

Within their assigned and limited field of operations, trade associations serve lawful and worthwhile purposes. The Supreme Court has ruled that trade associations may collect, analyze, and distribute market information regarding sales, shipments, and prices, but that to do so in order to restrict price competition among the members is a violation of the anti-trust laws.[8]

The doctrine of restraint of trade. Along with many traditions and the body of the common law that the early colonists imported from England, was a firm belief in the desirability of unimpeded competition between business enterprises. The courts have frowned upon any restrictions that tended to deprive the public of the benefits which flow from noninterference with trade. Before the days of giant combinations the question usually was presented in connection with the kind of restrictive agreement under which a seller of a business agreed to refrain from engaging in the same business in order to preserve to the buyer the goodwill of the business transferred. The courts in these cases formulated the general principle that any such agreement was an illegal restraint of trade when its effect might be to lessen competition.

At first the principle was applied with stern severity, the judges declaring any contract in *general* restraint of trade to be void, irrespective of special circumstances. In time, this rule was relaxed and restrictive covenants were upheld provided they were reasonable in view of all the circumstances. Note that this principle has nothing to do with the form that combinations take *per se*. The issues have been somewhat clarified by incorporation of the principle into statutes, which we shall presently treat. However, they are still a formidable, although not insurmountable, barrier to combinations.

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[8] Sugar Institute, Inc. v. U. S., (1936) 297 U. S. 553, 56 S. Ct. 629.

The common law doctrine of monopoly. Closely related to the doctrine of restraint of trade is that concerning monopoly. In commerce, the phenomenon is by no means new. History records attempts to effectuate what we today call monopoly far back in medieval times. A monopoly is an abuse of free commerce whereby one company or a group endeavors to get exclusive control over strategic sources of materials, means of production, or distribution within a given area for a product or service. Possessing such sole rights, the monopolist is in a position to dictate prices and terms and to stifle potential competition until it is exterminated or reduced to insignificance. Logically enough, the abhorrence by the common law of monopolies was much stronger than the antipathy to mere restraints of trade. It consistently condemned complete and partial monopolies in any recognizable guise. It is interesting to note that the first Constitution of Maryland expressed the generally accepted feeling by stating that monopolies are "contrary to the genius of a free government, and ought not to be allowed."

Litigation involving monopolistic practices was prolific in the nineteenth century. The position of the common law, i.e., the law before the enactment of Federal anti-trust legislation, was that any combination of corporations or individuals whose object was the "control of the market" for a product or commodity, was against public policy and unlawful. Similarly, a combination whose object was to increase charges unreasonably or to reduce facilities afforded the public was considered unlawful.

To determine whether a seller, or group of sellers, has the monopolistic power to control the price of a product, it becomes necessary to determine whether the seller controls the "relevant market," i.e., the market consisting of all products competing for the customer's favor. For example, the Government charged the du Pont Company with monopolization of the cellophane market because it produced almost 75 per cent of the cellophane used and sold in the United States. But the court ruled that the relevant market "is composed of products that have reasonable interchangeability for the purposes for which they are produced—price, use and qualities considered." Under this definition, the court found cellophane interchangeable with such products as waxed paper, glassine, aluminum foil, and others. Since du Pont's cellophane production constituted only 20 per cent of this market for "flexible packaging materials" it was not monopolistic.[9]

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[9] U. S. v. E. I. du Pont de Nemours & Co., (1956) 351 U. S. 377, 76 S. Ct. 994. But see U. S. v. du Pont, (1957) 353 U. S. 586, 77 S. Ct. 872, holding that in the du Pont-General Motors case the relevant market consisted of *automotive* paints and fabrics rather than all paints and fabrics sold by du Pont to industry. (These cases were decided under the Sherman Act which to a large extent incorporated the common law rules against monopolies.)

Unfair or deceptive acts or practices. Unethical trade practices in business had been dealt with by the ordinary processes of law, just as restraint of trade and monopoly had been. Among these were such unfair methods of competition and unfair and deceptive acts as false advertising, passing or palming off of one's goods as goods of another, and the like. As larger business units developed, the menace of unfair practices and their threat to the competitive system became greater. By means of price cuts and open or covert rebates to large customers of suppliers, the independent small business firm was placed at a competitive disadvantage. Besides price benefits, numerous other ways were used to extend tangible rewards to a large customer or to induce him to deal more or less exclusively with one supplier. The problem did not become acute until this century when it was met by specific legislation.

Legislative controls over combinations and their activities. The common law had definitely settled the question of legality of combinations where monopoly and restraint of trade were practiced. It might seem that statutes under such circumstances were superfluous. Nevertheless, first the states, and then the Federal Government, passed legislation to codify, clarify, and amend the common law rules.

In general, laws passed by the states were merely declaratory of the common law. But there was this difference, which was later extended by Federal acts, that restraints which at common law were merely unenforceable were expressly made illegal. Furthermore, the parties to such actions were made indictable, and injured parties were granted recovery rights against those who injured them. In practice, these state laws were comparatively useless. With few exceptions, enforcement was neglected and, if undertaken, was done so haphazardly. Moreover, many combinations were beyond the reach of the state laws because they were engaged in interstate commerce, which fell within the province of the national government.

The national government was obstructed in its approach to the problems of restraint of trade, monopoly, and unfair trade practices by the constitutional limitation which restricts it to dealing with interstate and foreign commerce. This limitation, however, did not deter Congress from passing numerous laws on the subject. These statutes constitute a great patchwork of loophole plugging and exempting enactments. Some of them improve procedural requirements; others extend the doctrines to bring special groups within the terms of existing legislation, or temporarily or permanently free such groups from this legislation.

In the history of intercorporate relations that follows, only the most important of the Federal laws will be given attention. Also, further

attention will be given to state laws where they fit into the chronological development of the history of combinations.

Approach to history of intercorporate relations. It is easy to get the impression from the history of combinations and the legal principles pertaining to them, that combinations were—and still are—rather iniquitous and malevolent organizations; that they were employed by unscrupulous, moneyed rogues and scoundrels to destroy competitors and to rob consumers by means of monopoly prices; that the promoters of combinations sneeringly regarded authority and the citizenry with a smug and contemptuous "public be damned" attitude. Until after the turn of the century leading editorial cartoonists took delight in portraying big business in just that way. Some still do. Happily, any such impression is entirely erroneous in so far as most combinations are concerned. Historical facts derived from legislative records of enactments that limit and prohibit certain combinations, and from court decisions, are very likely to present the evils rather than to extol the virtues of combinations. Accounts of the villains of big business and finance make better reading and tend to be remembered longer than stories of the far more numerous instances of successful organizations. Yet the latter have provided this country with an abundance of high quality goods and have helped materially to advance it to its present position of economic leadership.

The majority of combinations have not made much "history." Some of those which became well known because of spectacular legal actions against them were guilty of no evil intentions. They had inadvertently overstepped the faintly drawn and uneven boundaries of indefinite and poorly drawn legislation.

Public attitudes toward big business have swung like a pendulum from indulgence—and even friendliness and pride—to passionate and outraged antagonism. Periods of boom and depression have profoundly influenced the shifts in attitudes, as have the platforms of political parties that sponsored legislation concerning combinations. But underlying the many fleeting changes in public opinion there has remained steadfast and unshakable a jealous regard for free and unhampered competition and all that it implies.

If the reader will bear the above facts in mind, the pages that follow will be much more meaningful, and false conclusions will be avoided.

Intercorporate relations prior to 1893. In the pre-Civil War years, expansion toward the west and the constantly growing enterprises in the east very early emphasized the need for transportation facilities. The short line railroads of the time were by no means equal to the demands made upon them until many independent lines were joined, usually by consolidation, to provide uninterrupted trackage between

trading centers. Among the industrials, consolidations and mergers were not unknown, but the movement toward combination gained substance about 1861 when the cordage manufacturers consummated a formal pool agreement "to establish certain customs of trade." The depression immediately following the war lent impetus to the movement. Aggressive business leaders hoped to find in combinations a means to end disastrous cut-throat competition and to avert losses and failures. The pool arrangement seemed most appropriate to effect harmonious working relationships and many such unions were made. Among the better known of these were the Gunpowder Trade Association of the United States (1872), the Michigan Salt Association (1876), and the Steel Rail Pool (1887).

As indicated earlier in our discussion, after the use of pools was found to be ineffective, the trust device rose to prominence. Some of the largest industrial trusts came into existence in the two decades between 1873 and 1893.

Among them the most widely known were the Standard Oil Trust, formed in 1879, the Sugar Trust and the Whiskey Trust, both set up in 1887. Another significant development of the time was the emergence of the professional promoter and the rise to influence of the banker-promoter. The services of the latter were required to provide the substantial amounts of capital vital to huge business aggregations. Prior to this period, the sponsors of combinations were principally the businessmen themselves—operating, producing, and distributing officials.

To the masses it soon appeared that the trust arrangement had spawned a monster. The ruthless and merciless anti-social conduct of some of the greatest of the trusts in suppressing actual and potential competition in their struggle for monopoly powers soon brought the device and the organizations into disrepute. The financial manipulations of the rail tycoons added fuel to the fire. Emotional feeling ran high as indignant public opinion, stimulated by angry editorials and cartoons, goaded the government to take affirmative action to curb trust activities. These demands first resulted in tests of trust powers in the courts. On the basis of findings of illegality, dissolutions were ordered, and the death knell of the trust as a form of combination was sounded.

In 1888, New Jersey passed a law authorizing corporations to hold stocks of other corporations. Before that date, there had been sporadic attempts at intercorporate relations through stock ownership, and the potentialities of the device were recognized. However, the courts had consistently held that, in the absence of enabling legislation, the purchase of stock of other corporations was *ultra vires*. Other states quickly followed the lead of New Jersey in passing

enabling laws. This authorization, coming at a time when the legal future of the trust device was in doubt, cleared the way for use of the holding company form of combination to replace the discredited trust form. There was no question but that the device could be legally sustained. However, holding companies became involved in difficulties almost at once because some of them aimed at monopoly and carried on with the reprehensible programs of the trusts they superseded.

Interest in public utility combinations coincided with the development of the holding company form and opened up a vast new field for its exploitation. At the same time, the emergence of an investor class and the increasing importance of the national securities market encouraged the formation of combinations.

Nevertheless, the politicians, having bound themselves with a great deal of resounding oratory to fight monopolists and those who would impede free competition, were forced to redeem their pledges with action. The Anti-trust Act of 1890—The Sherman Act—was the Federal legislative remedy.

The Sherman Act. This law is entitled: "An act to protect trade and commerce against unlawful restraints and monopolies." It declares illegal every contract, combination in the form of a trust or otherwise, or conspiracy, in restraint of interstate trade and commerce. It makes it a punishable misdemeanor for any person to monopolize, attempt to monopolize, combine or conspire with others to monopolize, any part of the trade or commerce among the several states, or with foreign countries.[10] It provides necessary definitions, establishes procedures to be followed in anti-trust actions, and determines punishments to be inflicted upon persons convicted of violations.

The Act, in effect, extends but does not basically change the common law policy, formerly applied only in the state courts, to interstate commerce and the national scene. It defines illegal action in the common law terms of "restraint of trade" and "monopolizing" without defining these ambiguous terms or differentiating between them. It leaves open the important question of whether all collusive agreements are bad or only those that *unreasonably* restrain trade. It was thus left to the courts to determine the applicability of the Act. Since many of these decisions occurred some years after the law was enacted, and we are here giving a historical review, we shall discuss the interpretations in their chronological sequence.

Intercorporate relations from 1897 to 1918. The Sherman Act and the depression that followed the panic of 1893 temporarily discouraged further interest in business unions. In 1897, in an atmosphere

[10] In 1918 the Webb-Pomerene Act was passed to permit certain restrictive activities by export associations.

of relatively favorable public opinion, the movement began anew and continued vigorously until the depression of 1903 again called a halt. The decision in 1904 which ordered dissolution of the Northern Securities Company [11] on the ground that it constituted a monopoly was a sharp blow to the hopes of those who had placed their confidence in the holding company form of combination as invulnerable to those attacks which had made the trust form impossible.

During the period from 1905 to the end of World War I, there were fewer combinations formed than previously. Some large firms were still under sharp attack and governmental policies with respect to them were fluid and undergoing marked changes. Distinctions were being drawn between "good" and "bad" combinations, or "trusts" as they were popularly called regardless of the legal form they used. The following summary of interpretations of the Sherman Act in this period shows the background of the reticence of the combination movement. In 1914 the Clayton Act was passed to correct abuses which the Sherman Act had failed to cover, and the Federal Trade Commission Act was passed to deal with unfair methods of competition.

Interpretation of the Sherman Act. The Supreme Court of the United States has been called upon many times to render decisions in anti-trust actions. A number of these decisions have been close with strong and well-reasoned dissents by clear-thinking and respected justices. Initially, the Court interpreted the Act rather strictly, holding that contracts in restraint of trade included *all* agreements of that nature without exception or limitation and were not confined only to those constituting *unreasonable* restraint of trade.

In decisions rendered in cases brought against the Standard Oil and the American Tobacco Companies, the Court moderated its view and relaxed the rigid rule it had followed until then.[12] In those cases the Court held that all of the pertinent circumstances surrounding alleged violations must be considered and a "rule of reason" applied to determine whether or not the acts or combinations complained of are illegal. The Court felt that the terms used in the Sherman Act had well-known meanings in the common law and that Congress intended them to have the same meaning in the Act. Basing its definition on precedents in the English and some American courts, the Court concluded that only those agreements which restrained trade *unreasonably* were unlawful. This decision was criticized for amounting to "judicial legislation" but it is worth noting that Congress, although it has had more than 45 years to do so, has never taken the

[11] Northern Securities Co. v. U. S., (1904) 193 U. S. 197, 24 S. Ct. 436.

[12] Standard Oil Co. v. U. S., (1911) 221 U. S. 1, 31 S. Ct. 502, and U. S. v. American Tobacco Co., (1911) 221 U. S. 106, 31 S. Ct. 632.

opportunity to overrule the Supreme Court and clarify the meaning of "restraint of trade" and "monopoly."

Cases decided after 1914 deal not only with the Sherman Act but with the Federal Trade Commission Act and the Clayton Act as well.

The Clayton Act. The Clayton Act was passed to bring within the coverage of the anti-trust laws abuses that experience had shown were inadequately provided against in the Sherman Act. It defined certain unreasonable acts, including some unfair trade practices. The following acts are among those declared to be unlawful *where the effect is substantially to lessen competition, or where they tend to foster a monopoly:* (1) discriminations in prices between purchasers, (2) leases and sales in which the lessee or buyer must agree not to use commodities of a competitor of the lessor or seller, (3) acquisitions of stock of other corporations. In addition, the Act forbids interlocking directorates under certain conditions (see page 411).

Federal Trade Commission Act. The Federal Trade Commission Act, passed in 1914 shortly before the Clayton Act, declares unfair methods of competition in interstate commerce unlawful. It was an innovation in regulatory laws in that it is in the nature of preventive legislation. The specific practices enjoined were misrepresentations such as false advertising, practices tending toward monopoly or restraint of trade, exclusive tying contracts, price-fixing agreements, resale price maintenance, and others. The Act is administered by the Federal Trade Commission, which investigates acts alleged to be unfair, holds hearings, and issues orders compelling guilty persons to desist from use of unfair trade practices.

Intercorporate relations from 1918 to 1929. After World War I, another upsurge in corporate combination took place. One important factor was the Supreme Court decision in the United States Steel case [13] that the mere size of a corporation does not constitute a violation of the Sherman Act. Also, application of new techniques of production and scientific management had instituted economies and occasioned remarkable increases in efficiency. Simultaneously, prices declined and competitive practices sharpened. During the prosperous years from 1925 to 1929 the movement gained considerable vigor. Prosperity and ease in marketing securities, especially equities, encouraged promotions. The union of companies by means of holding company relationships, particularly in public utilities, continued unabated. The abuses of the device in the electric and gas field, of which we shall have more to say in the chapter on holding companies, caused Congress to initiate extensive inquiries into the nature and activities of such combinations.

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[13] U. S. v. United States Steel Corp., (1920) 251 U. S. 417, 40 S. Ct. 293.

Intercorporate relations from 1929 to 1940. Economic and political conditions were not conducive to great interest in expansion by combination during the thirties. Reorganization and refunding, rather than combination, was the major concern of many corporations. The National Industrial Recovery Act of 1933 promoted co-operation among and within industries. Later, when the Act had been declared unconstitutional, some of the co-operative associations survived. A few of them were promptly subjected to anti-trust actions.

Congressional hearings resulted in the wide publication of impressive facts concerning the extent of concentration of wealth in large corporations and put them on the defensive.[14] With the passage of the Public Utility Holding Company Act of 1935 the electric and gas distribution companies were compelled to begin simplification of their over-complicated structures. The trend in all fields was toward elimination of excessive concentration of control over productive and distribution facilities and elimination of complex business relationships which such concentrations made possible. In the late thirties the possibility of America's becoming involved in the European and Asiatic wars made the future of business and of the nation too doubtful to invite firms into new risks and costly ventures. The Clayton Act showed itself to be an ineffective tool in combating price discrimination. It could not be used to protect the small dealer against price advantages obtainable by large-scale buyers, especially chain stores. The Clayton Act provisions against price discrimination could be evaded by making a small difference in quantity the basis for a large difference in price or by giving the large purchaser price concessions in the form of brokerage fees or advertising allowances. To close these loopholes, the Robinson-Patman Act was passed in 1936.

Robinson-Patman Act. This Act makes it unlawful for a buyer in interstate commerce knowingly to induce or receive a price discrimination prohibited by the Act. Normal and customary trade allowances are permitted, but unearned brokerage fees are outlawed as are advertising and other allowances not made available to all competing customers on proportionally equal terms.

Intercorporate relations since 1940. Upon this country's entry into World War II, co-ordination and temporary association of whole industries took place with government help and sanction. From 1940 through 1946 larger companies took over 1,800 smaller companies, according to a report made by the Federal Trade Commission to

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[14] See pages 425 et seq. In the hearings on bills proposing the Federal licensing of *corporations, introduced in the 75th Congress, Third Session (1938), an impressive* list of facts, summarized from various sources dating from 1926 to 1931, was placed in the record to show the extent of concentration in the business world. See pages 512, Part 4 of the Hearings.

Congress.[15] More than one-third of these mergers took place in three industries where small enterprises had predominated: food, non-electrical machinery, and textiles. About 60 per cent of these mergers were horizontal acquisitions, representing the buying up of firms producing similar products for similar markets. At the same time there was considerable vertical expansion by manufacturers buying up suppliers principally because demand for materials had been outrunning supplies.

The post-war era saw an increasing number of mergers as well as an increase in the number of anti-trust suits filed by the Government. By the middle fifties, the rate of industrial mergers was fast approaching the record set in the late twenties. The Government's power to stop corporate combinations was at first limited by the fact that Section 7 of the Clayton Act only prohibited the acquisition of *stock* in one corporation by another where the effect of such acquisition would be "substantially to lessen competition or tend to create a monopoly." But this left corporations free to buy up the *assets* of competitors. This loophole was closed in 1950 when Congress amended the Act to prohibit acquisition of assets under the same conditions that stock acquisitions are prohibited.

The Federal Trade Commission and the Justice Department, both of which are charged with enforcing the "anti-merger" provisions of the Clayton Act, have adopted an informal "merger clearance procedure" enabling companies to consult with a Government agency to determine whether the proposed merger or acquisition will be considered objectionable and result in the institution of an anti-trust action. Upon presentation of the facts, the company may convince the Government that the merger, even if it involves major competitors, will not lessen competition. Thus the Government took no action against the Studebaker-Packard consolidation or the merger of the Nash and Hudson companies to become American Motors since these combinations would tend to strengthen rather than lessen competition in the automobile industry. However, the Government would not approve the merger of two major steel companies and instituted action against Bethlehem Steel and Youngstown Sheet & Tube when those companies agreed to combine despite Government disapproval.

The Government acquired another weapon for its anti-trust arsenal with the Supreme Court's 1957 decision in the du Pont-General

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15 "The Present Trend of Corporate Mergers and Acquisitions," Letter from the Acting Chairman of the Federal Trade Commission, 1947, 80th Congress, 1st Session, Senate Document No. 17. For a study showing that the merger movement did not significantly increase industrial concentration, see "Effect of Mergers on Industrial Concentration," 1940–1947, John Lintner and J. Keith Butters, *The Review of Economics and Statistics,* Vol. XXXII, No. 1 (February, 1950).

Motors case.[16] Up to the time of this decision it had been generally thought that Section 7 of the Clayton Act applied only to "horizontal acquisitions," i.e., the buying up of competitors. In fact, for 35 years the Government had not attempted to invoke Section 7 against "vertical acquisitions," i e., purchases of customers or suppliers, and the Federal Trade Commission had stated that Section 7 did not apply to vertical acquisitions.[17] Despite this background, the Government in 1949 had charged du Pont with a violation of Section 7 because it had acquired a 23 per cent stock interest in General Motors between 1917 and 1919, allegedly for the purpose of entrenching itself as the principal supplier of GM's paint and fabric requirements. The Court upheld this claim, ruling that Section 7 prohibited not only the acquisition of stock of a competing corporation, but also the acquisition of the stock of *any* corporation, competitor or not, "where the effect may be to restrain commerce or tend to create a monopoly of any line of commerce."

This decision has been interpreted to mean that "every corporation which has acquired a stock interest in another corporation after the enactment of the Clayton Act in 1914, and which has had business dealings with that corporation is exposed, retroactively, to the bite of the newly discovered teeth of Section 7." [18] It has also been suggested that if this decision relating to vertical stock acquisitions is read together with the amended Section 7 covering assets as well as stock acquisitions, few large-scale industrial units are likely to remain immune from attack under Section 7.[19]

Other commentators saw little reason to expect drastic changes in the Government's anti-trust campaign. For one thing, there are few comparable cases. Rarely does one corporation own so much stock (23 per cent) in another corporation over so long a period of time (40 years) without attempting a merger and commingling of assets. Actions against corporations which have physically combined have rarely been successful since it is difficult to "unscramble the eggs" once they have been scrambled.[20] Nor did the Government, after instituting the du Pont action in 1949, take action against many other vertical integrations. In the war and early post-war years, when raw materials were in short supply, manufacturers insured their interests by buying into companies which could supply them with their basic needs. In the early fifties, vertical integration began to move in the opposite direc-

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[16] U. S. v. E. I. du Pont de Nemours & Co., (1957) 353 U S. 586, 77 S. Ct. 872.

[17] FTC, *Report on Corporate Mergers* 168 (1955).

[18] Mr. Justice Burton dissenting in U. S. v. du Pont (1957) at 353 U. S. 611, 77 S. Ct. 886.

[19] "The Supreme Court, 1956 Term," 71 *Harvard Law Review* 1678 (1957).

[20] See Farm Journal, Inc., FTC Order No 6388, 7–17–56.

tion, manufacturers buying up firms which would provide an outlet for their products. The fact that such integrations were often for the very purpose of strengthening a company's competitive position and posed no threat of monopoly might be reason enough to explain why these mergers did not result in anti-trust action. But equally significant may be the fact that the Government often did not learn of these acquisitions in time to prevent them.

To remedy this situation, a "pre-merger notification" bill was proposed in Congress in 1956. The bill provided that corporations planning to merge into a resulting corporation which would have assets of more than $10,000,000 would have to give the Justice Department or the Federal Trade Commission 90 days notice of the proposed merger. The bill would not have given these Government agencies any veto power over pending mergers but would have only given them enough time in which to gather sufficient information on which to base a decision to sue or not to sue. (At present, these agencies must rely on financial newspapers, trade journals, and the like to learn of impending mergers.) The bill passed the House overwhelmingly in 1956 but no action was taken on it by the Senate. In 1957, a House Committee recommended passage of a similar bill with a 60-days notice provision but no final action was taken by either house.

In the field of price discrimination, the fifties also saw renewed judicial activity and legislative interest. The Robinson-Patman Act (see page 452) provides that a seller may refute a charge of price discrimination by showing that his lower price was made in good faith to meet an equally low price of a competitor. The Federal Trade Commission at first took the position that a seller could lower his price only when this would not injure competition; in other words, "good faith" was no defense if the price cut would have hurt competitors. But the Supreme Court overruled the FTC. It held that if a lawful lower price of a competitor threatens to deprive a seller of a customer, the seller may in good faith meet the lower price in order to keep the customer, regardless of the effect on competition.[21]

A bill was introduced in Congress in 1955 which would have made the FTC's original interpretation the law. It would have permitted a good faith lowering of prices only where this would not injure competition or create a monopoly. Supporters of the bill argued that the Supreme Court's decision opened the way for sellers to lower their prices even if this resulted in destroying competitors. Opponents of the bill, on the other hand, argued that competition requires that sellers be free to meet the prices offered by others without having to decide on the spot whether a court or the FTC might at some later

[21] Standard Oil Co. v. FTC, (1951) 340 U. S. 231, 71 S. Ct. 240; (1958) 78 S. Ct. 369.

date find that the price reduction had injured competition. The House passed the bill by a vote of 393–3 in 1956 but it died in the Senate that year. It was reintroduced in 1957 but no action was taken on it.

Summary. Combinations may be legally effected through consolidations, mergers, sales of assets, leases, and holding companies. Intercorporate relations through interlocking directorates are still permissible, though, as has been indicated, they are prohibited or controlled by legislation under a variety of circumstances. As the history of combinations shows, economic conditions and governmental and public attitudes toward "big business" exert a strong influence in trends toward or away from unions of existing companies.

Combinations have had a complex and disturbing impact upon our national economy and the question of what to do about them has been and still is perplexing. The anti-trust laws prevent combinations where the effect is to restrain trade or create monopolies. Regulatory acts, both Federal and state, outlaw unfair methods of competition. But uncertainties and conflicting thoughts still prevail concerning the problem of illegal combinations.

Considerable thought was given to these problems in recent years by a special committee of lawyers and economists appointed by the Attorney General.[22] The Committee was instructed by the President "to prepare the way for modernizing and strengthening our laws to preserve American free enterprise against monopoly and unfair competition." [23] In regard to the Sherman Act, the Committee approved the use of the "rule of reason" (see page 450) which "permits the courts to decide whether conduct is significantly and unreasonably anticompetitive in character or effect." [24]

The Committee recognized that there is a conflict between the Sherman Act philosophy of "hard" competition and the Robinson-Patman Act philosophy of "soft" competition, i.e., its protection of the small businessman from the rigors of unbridled competition. Although favoring the Sherman Act approach, the Committee did not recommend any basic changes in the Robinson-Patman Act. However, in accord with its basic philosophy, it favored the Supreme Court's Standard Oil decision [25] giving sellers the absolute right to meet competition and thus opposed the proposed legislation which would overrule that decision (see page 455).[26]

We have thus seen how almost seventy years after the anti-trust

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[22] See *Report of the Attorney General's National Committee to Study the Antitrust Laws*, March 31, 1955.

[23] Statement by President Eisenhower, quoted in the *Report* (see note 24) at p. IV.

[24] *Report* (see note 22), p. 11.

[25] See note 21.

[26] For an analysis of the various aspects of the Committee's Report, see a series of six articles at 53 *Michigan Law Review* 1033–1152 (1955).

concept became a basic part of our national legal and economic philosophy, the problems of intercorporate relations are still unsettled. The basic philosophy of 1890 (the Sherman Act) to foster free competition and bar monopolies still remains. This philosophy has been extended or modified by the Clayton and Federal Trade Commission Acts, the Public Utility Holding Company Act, and the Robinson-Patman Act as the demands of our changing economy have demonstrated the need for changes. Much serious thought has been given to the need for further extension and modification as our economy continues to expand and change. No doubt both the thought of the theorist and the experience of the businessman will influence the changes in concepts and law that will continue to take place in the years to come.

Research Question

Is the merger movement gaining new momentum or is it declining? To support your answer (a) cite statistics from standard sources contrasting the merger movement in the fifties with the merger movement in previous decades, starting with the twenties, and (b) from current or recent periodicals, give the opinions of one or more authorities on the merger outlook for the future.

Problem

The White Company sells 1,000 pounds of hides to the United Manufacturing Co. at 50 cents a pound. Another salesman, in order to get Hicks Corp. as a customer, quotes the same quality hides at 48 cents for a 1,100-pound order. Both customers manufacture leather goods and sell in the same market. (a) Is the White Company violating the Robinson-Patman Act? (b) Suppose the order of Hicks Corp. is for future delivery; does that make the different price permissible? (c) Suppose the Black Company has offered to sell 1,000 pounds to Hicks at 48 cents; would that make White's quotation of 48 cents permissible?

CHAPTER 23

Consolidation and Merger

Distinction between consolidation and merger. The terms "consolidation" and "merger" have already been defined.[1] Let us say, in review, that the consolidation of companies *A*, *B*, and *C* has somewhat the same effect as the pouring of three different solutions into a single glass. Perhaps an even better way to get at the effect of consolidation is to liken it to the organization of a corporation by other corporations whose identities are lost in the company they form. The merger of companies *A* and *B* into company *C* has somewhat the same effect as pouring two different solutions into a glass which already contains another solution. In other words, in a merger, one or more corporations are fused into one already in existence. As previously explained, the distinction here made between consolidation and merger is not always observed in financial parlance. However, the distinction will be maintained in this discussion.

The problems of consolidation and merger. Three fundamental questions present themselves in any study of expansion through consolidation or merger: (1) How is the consolidation or merger legally effected? (2) What rights and obligations flow out of the intercorporate relations established by means of a consolidation or merger? (3) What are the bases upon which the ownership in the new or surviving organization shall be distributed?

How consolidations and mergers are effected. Just as an enabling act is required as the basis of a corporation, so is a statute permitting consolidation required as the basis of a consolidation. If a consolidation is undertaken without statutory permission, the constituent companies are guilty of an *ultra vires* act.

Where the corporations about to be consolidated were originally

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[1] See page 441.

organized in different states, the consents of the several states must be obtained. The statutes vary from state to state not only on the procedure for effecting a consolidation, but also on the kinds of corporations which may consolidate. In many of the states only domestic corporations may combine, while in others the statutes definitely permit domestic and foreign corporations to consolidate. In some states, the consent of a majority of the outstanding shares is required to approve the consolidation; in others, two-thirds or three-fourths must approve.

The procedure in consolidation is ordinarily as follows: The directors of the several companies agree upon a plan for the consolidation. They work out the ratio of the shares of the new corporation to be issued for the shares of the absorbed corporations, the proposed list of directors and officers of the new corporation, the business and dividend policies of the combining corporations until the consolidation is consummated, the rights of each corporation to investigate the others, and the rights of each corporation to abandon the consolidation in case of material adverse findings, and the like. The directors of the several companies then pass resolutions approving the consolidation and calling meetings of stockholders to vote upon the proposal. If the consent of the required number of shares outstanding is obtained, a written agreement of consolidation is executed and filed in the public offices wherein certificates of incorporation are filed. The exact form of this certificate will depend upon the wording of the statute under which the consolidation is organized. Thereupon the consolidated company comes into being, and there remains only the exchange of certificates of stock of the consolidated company for the stock of the constituent companies.[2]

In general, the same procedure applies to mergers, except that instead of a new corporation there is a surviving corporation.

Objecting stockholders. People familiar with such affairs realize that whenever any form of corporate combination takes place, there are always some stockholders or creditors ready to raise objections. Sometimes objections are made in good faith. Frequently, however, the objectors oppose the union for the purpose of forcing a settlement of their claims on a basis hardly to be distinguished from blackmail. It is important, therefore, that when corporations consolidate or merge, they follow exactly the terms of the statute authorizing the union.

A dissenting stockholder may have two grounds for objection:

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[2] Consolidation of interstate railroads is under the control of the Interstate Commerce Commission. Consolidations to effect simplification of the corporate structures of holding companies subject to the Public Utility Holding Company Act of 1935 are under the control of the Securities and Exchange Commission.

(1) the proposed consolidation is illegal; (2) the stockholder does not deem it expedient. To protect himself from injury on ground (1), he may start an action in an equity court for an injunction against the combination, and to protect himself against ground (2), he may have recourse to certain statutes provided in most states for the protection of minority stockholders who do not wish to be forced into a consolidation or merger against their will. These statutes, known as *appraisal statutes*, usually provide for payment to dissatisfied stockholders of the appraised value of their shares as of the time of the consolidation or merger.

The statutes vary in detail from state to state, but a typical statutory provision requires the dissenting stockholder to file a written objection to the consolidation or merger before the stockholders vote on the proposal to merge. Within a given period after the merger agreement has been filed with the state authorities, he must make a written demand on the corporation for payment. If the corporation and the stockholder cannot voluntarily agree on the value of the stock, either party may apply to a court and demand valuation of the stock by an appraiser appointed by the court. The court, after considering the appraiser's report and exceptions to it raised by the parties, issues a decree determining the value of the stock and ordering payment by the corporation. From a practical standpoint, the appraisal statutes have superseded the dissenting stockholder's common law right to bring an action in a court of equity to recover his shares.

Should too many stockholders demand appraisal, the amount of cash required for payment would place a heavy strain upon the new or constituent corporations. Since the directors usually cannot be sure of how great a demand dissenters will make until after the stockholders have approved the merger or consolidation, agreements today usually contain a clause giving the board of directors of all merging or consolidating companies the right to abandon the plan if the potential liability to dissenters is so great that the proposed merger or consolidation would be impractical.

Rights of stockholders consenting to consolidation or merger. Usually the stockholders of the constituent corporations become the stockholders of the consolidated or the acquiring corporation upon an agreed basis, and their rights are governed accordingly. The rights of stockholders of a constituent company to dividends declared but not paid are not affected by the consolidation or merger. Such dividends are a debt, and the new corporation is bound to pay the debt on the general principle that it assumes the debts and obligations of the combining companies. Past accumulations of dividends, that is, arrears on cumulative preferred stock, are usually taken into account when the plans are being made. Part or all of the accumulation may

be paid off, or the ratios of the exchange may be made more favorable for this group of stockholders. The courts have held that dividends accumulated on preferred stock may be extinguished by merger of the corporation, if the merger provisions are fair and equitable.[3]

Rights of creditors. Although a consolidation or merger may be entered into without the consent of the creditors of the merging companies, the statutes generally provide that the debts and liabilities of the former corporations shall attach to the consolidated corporation, and be enforceable against it to the same extent as if the debts and liabilities had been incurred by the consolidated corporation.

If a creditor has a specific lien upon the property of one of the merging corporations, that lien is not disturbed, unless the holder of the specific lien otherwise agrees.

Effects of consolidation on after-acquired clauses in corporate mortgages. Companies frequently have after-acquired clauses in corporate mortgages covering all their properties. Since these corporate mortgages frequently secure large bond issues, and since the holders of other bond issues may also be interested in consolidations, we must consider the effect of consolidation on bondholders whose claims are secured by mortgages with after-acquired clauses.

Some effect would undoubtedly be given by the courts to the consolidation agreement if it made reference to the mortgages of the constituent companies and gave the holders of bonds secured by such mortgages certain rights under the consolidation agreement. In practice, however, it is usual to close the mortgages of the constituent companies and if any further issues of bonds are necessary, to make them under a new and larger consolidatea mortgage. It is therefore to the interest of the consolidated company to restrict the lien of the mortgages of the constituent companies to the properties which the several constituents contribute to the consolidation, and to prevent such underlying mortgages from attaching to after-acquired property. In this way the security behind the new consolidated mortgage will be stronger. It is quite clear that when several companies consolidate, one constituent cannot be said to be "acquired" by the other in such a way as to make the mortgage of the latter company cover the property of the former under the provisions of an "after-acquired" clause.

Basis for distributing ownership in new or surviving corporation. The method by which the consolidation or merger is effected is important in determining the basis for distributing the ownership in a new corporation, in case of consolidation, and for exchanging the securities of corporations that are being absorbed for those of the sur-

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3 Federal United Corporation v. Havender, (1940) 24 Del. Ch. 311, 11 A.(2d) 331, rev'd 6 A.(2) 618; Hottenstein et al. v. York Machinery Corp., (1942) 45 F. Supp. 436.

viving corporation, in case of a merger. The methods of bringing about a consolidation or merger may be described as the *bargaining* method and the *option* method. In recent years the bargaining method has become the principal one used.

Bringing about the merger or consolidation. In a typical modern merger, a large corporation wishing to expand by absorbing a smaller corporation that has the facilities needed by the large corporation may know of some company with which it would like to combine. The president of the large corporation may go directly to the president of the small corporation and try to interest him in the merger proposition, in a sale of the assets, or in a sale of a controlling interest in the company. Brokers may represent one or both parties. Or the sale may be negotiated by an investment banker, an attorney, or a consultant representing either corporation. If the smaller corporation is interested, it will furnish the corporation proposing the merger with financial statements and other data necessary to work out the deal.[4] If the shares of the acquiring corporation and of the corporation to be absorbed have a clearly established market price, it is fairly simple to arrive at an equitable basis for effecting an exchange of securities. But if the shares of the corporation that is to be absorbed are not bought and sold on an exchange or over-the-counter, those who are negotiating the deal must determine the relative values of the shares of both corporations by bargaining and must arrive at a basis for an exchange of stock that will meet with the stockholders' approval. Thus, this arrangement is referred to as the *bargaining* method of merger.

In the post-war merger boom many mergers were also initiated by a corporation wishing to sell out. One of the major reasons for this trend was the need of owners of small, closely-held corporations to obtain enough funds to pay estate taxes. It is almost impossible to predict what the Government's evaluation of an estate will be where a major portion of the estate consists of corporate stock with no established market price. If the close corporation is sold to a larger one, the owners will receive cash or marketable securities, thus eliminating the problem of valuation for their estates and at the same time providing the needed liquidity for paying the estate taxes. Also, a small business may have difficulty raising needed capital; selling out or merging with a larger, better-financed organization may be the better

[4] Sometimes investment bankers are instrumental in finding a small, closely-held corporation which the expanding corporation might be able to acquire. The banker in that case will approach the president of the small corporation to see whether the owners would be interested in the proposal. Where the negotiation is carried on by the investment banker, the smaller corporation, if interested, will furnish the banker with financial statements and other data necessary to work out a plan for combining the two businesses.

solution. Often a family-owned corporation will lack capable management or be unable to train good managers to succeed the current management team. Such companies may wish to sell out to a larger, well-managed corporation.

The *bargaining* method is also the term applied to the efforts of an outside promoter to bring about the fusion of two or more corporations. He estimates what the total earnings will be after consolidation has been effected; that is, to present actual earnings he adds the anticipated savings of consolidation. The total is then capitalized at a fair rate. He then negotiates with the various companies so that a portion of the securities is left for him as compensation for his promotional services. This method has also been called the Morgan method after one of its most successful exponents.[5]

In the *option* method of consolidation, the promoter secures options on the assets or securities of the several companies, contracting to take up the option within a given time. A new company is then formed, or the surviving company is recapitalized, and its securities are offered to the selling companies. The difference between the amount of securities necessary to attract the selling companies, and the total capitalization, constitutes the proceeds to the promoter.[6]

Valuation. In order to arrive at a fair basis for an exchange of stock in a merger or consolidation, it is essential that each of the constituent companies be carefully analyzed. This step usually involves an investigation, by experts, into the accounting practices and policies of the companies so that adjustments may be made in their balance sheets and income statements to permit proper comparison of their respective financial worths. It also includes a study of the charactersitics and efficiency of each company's property with a view to seeing the best use that might be made of each company's contribution to the merger. In addition, an economic survey must be made to be sure that the proposed combination is sound from the viewpoint of demand and competition. In such a survey, the reaction of the employees, investors, and the public to the proposal will also be considered. Attention must also be given to the legality of the proposed combination from the standpoint of the anti-trust laws.

Especially important in the analysis is the valuation of assets and earning power of each of the constituents, to arrive at a proper capi-

[5] For a discussion of this method as applied to the United States Steel Corporation, see A. Cotter, *Authentic History of the United States Steel Corporation* (New York: Moody Magazine & Book Company, 1916).

[6] The option plan may be called the Flint plan because this method was frequently and successfully used by Charles R. Flint. See his *Memories of an Active Life* (New York: G. P. Putnam's Sons, 1923) for a description of the option plan as applied to the formation of the United States Rubber Co. (at pp. 298–300).

talization of the enlarged company and a sound capital structure. Some of the methods that are used in the valuation of properties and earning power will now be treated.

Valuation of properties. The problem of valuing the properties of the constituents is somewhat different from the problem of capitalization. For example, it may be planned to merge companies *A* and *B* into *C*. The problem here is, how much are the properties of the several companies worth separately? The problem of capitalization is to determine how much they will be worth when brought together.

Several methods of valuation may be mentioned. The first may be called scientific appraisal. In this method a definite and more or less scientific plan is agreed upon and the actual figures to be paid are arrived at by applying the plan to the property. Thus, a patent on an automobile accessory may be valued somewhat as follows: Assume that one in every 100 automobile owners will buy a device once in two years, and will pay a profit of one dollar. The annual profits may then be capitalized at 20 per cent and the result will be the price of the patent. Real estate, it may be agreed, shall be valued by taking late sales in the neighborhood and applying rules of appraisal understood by expert real estate operators and appraisers.

The second method is to have an independent appraisal made of the value of the land, buildings, machinery, and equipment of the constituents. The appraisals, together with the balance sheets covering several years past, might then be given to a committee composed of one representative of each concern, with the promoter or some other disinterested person or persons as an arbiter. The committee finally decides on the valuations of the properties. The committee may also determine, with the aid of independent auditors, and upon examination of income statements for several years past, what is the earning power of each constituent on the basis of which its intangible properties will be valued. Sometimes the whole matter is turned over to one or more outside parties in whose ability and integrity the constituents have implicit confidence, or to a professional appraisal firm.

A third method may be called negotiation. The negotiators agree upon a price, being guided, perhaps, though not necessarily, by some scientific rules of valuation. Frequently, valuations are made by negotiating for part of the property and agreeing upon terms of an appraisal for the rest.

Valuation of earning power. Perplexing problems always arise in determining the income of a corporation. For example, if one constituent has a record of large salaries and small dividends and the other has paid small salaries and large dividends, adjustment must be made to arrive at an equitable result. Frequently the Gordian knot is

cut by agreeing that all *salaries* of managers, officers, and similar top employees (as distinguished from wages paid to ordinary employees) shall be added back in calculating the net earnings.

The same problem is likely to arise in connection with insurance, money actually spent for repairs, renewals and uncapitalized betterments, and arbitrary allowances for depreciation. The better plan is to provide that all items thus subtracted in the accounts of the several companies in calculating net earnings shall be added back and that there shall be uniformly subtracted for each of these purposes some percentage of the assets to which they apply: for example, 2 per cent of the plants, machinery, and so forth, for insurance; 3 per cent for depreciation; and 2 per cent for repairs, replacements, and similar items.

Adjustment must also be made for items of income or loss that are non-recurrent. Thus, profits such as gains on the sale of marketable securities owned by the company, profit on the sale of some fixed asset, and losses due to damage that is not covered by insurance, would be subject to adjustment in arriving at the earning power of constituents.

Also, the period over which earnings are averaged is important. It would be patently absurd to choose the earnings of any one year. On the other hand, if one company is very young and the rest old, it would probably be unfair to average the earnings over a number of years, since most businesses during their early years show relatively small earnings. Experiments of production, the costs of early advertising, the expense of building up a proper personnel in various departments—all these items eat into earnings in early years. Some allowance certainly must be made. Where all the companies have established records, the number of years to be averaged in determining earning power should be large enough to include a period of general business prosperity and one of general business depression.

Illustration of a plan of consolidation. To illustrate the practical working out of a plan to consolidate the operations of two companies a comparatively simple example has been chosen. Remington Rand, successor to a corporation founded in 1873, and Sperry Corporation, which had been operating since 1910, decided to unite in 1955 and form Sperry Rand Corporation. The basic reason for the consolidation was, according to Sperry's proxy statement, to facilitate the development of new products involving the techniques of both companies. The combined company would enjoy the technical knowledge and skills of the two companies, each a leader in different fields of electronics. There was virtually no duplication in the activities of the two companies. Instead, they were mutually complementary, and the

unification would provide broader coverage in the expanding field of electronics.

Sperry corporation stockholders were to receive 3¼ shares of the new Sperry Rand common for each share of their Sperry common. Remington common stockholders were to receive 2 shares of Sperry Rand for each share of Remington common. Remington preferred stockholders were to receive one share of Sperry Rand preferred in exchange for each share of Remington preferred. (Sperry had no preferred stock.) Sperry Rand, the new consolidated corporation, would pay to dissenting stockholders of either of the two consolidating corporations the fair value of their stock.

As explained above, the ratio for exchanging the securities of the two corporations is determined by a consideration of the market price of the securities before merging, the earnings and dividend records of the two companies, and various other factors. The following table gives the high and low sales prices of the common stock of Sperry and Remington for each of the eight quarterly periods immediately preceding the vote on merger:

Quarter	*Remington Common*		*Sperry Common*	
	High	*Low*	*High*	*Low*
1953, 2nd Q.	18½	15	47	40¾
1953, 3rd Q.	16⅜	13⅝	42⅞	35¾
1953, 4th Q.	15¼	14	47½	41½
1954, 1st Q.	17¾	14¼	57⅜	43¼
1954, 2nd Q.	19⅛	16⅝	63	54¾
1954, 3rd Q.	28⅜	18⅛	81⅜	59⅝
1954, 4th Q.	36½	26⅜	77 [7] 45⅞ [8]	68¾ [7] 34½ [8]
1955, 1st Q.	48⅝	31¼	57 [9] 65⅜ [10]	39¾ [9] 45 [10]

The positions of the two companies matched up as follows before the consummation of the plan:

	Remington Rand	*Sperry Corp.*
Common stock outstanding [11]	5,163,523	4,343,590
Book value per share of common stock [12]	\$19.53	\$22.94

The net income, per share earnings, and dividends paid are shown in the accompanying tables.

[7] Before two-for-one stock split, effective October 11, 1954.
[8] After two-for-one stock split.
[9] Before 5 per cent stock dividend, March 1955.
[10] After 5 per cent stock dividend.
[11] As of December 31, 1954.
[12] As of December 31, 1954, adjusted in the case of Sperry for the 5 per cent stock dividend paid in March 1955.

REMINGTON-RAND: NET INCOME, PER SHARE EARNINGS, DIVIDENDS PAID, FOR YEARS ENDED MARCH 31, 1953, 1954, AND 1955

		Earnings Per Share		
Year Ended March 31	*Amount of Net Income*	*Before Preferred Dividends*	*After Preferred Dividends*	*Per Share Dividends* *
1953	$14,151,000	$2.74	$2.65	$1.00
1954	12,211,000	2.37	2.28	1.00
1955	16,127,000	3.12	3.03	1.00

* On common stock; a dividend of $4.50 was paid in each of the three years on each preferred shaie.

SPERRY CORPORATION: NET INCOME, PER SHARE EARNINGS, DIVIDENDS PAID, FOR YEARS ENDED DECEMBER 31, 1952, 1953, AND 1954

Year Ended December 31	*Amount of Net Income*	*Earnings Per Share*	*Per Share Dividends*
1952	$13,930,044	$6.75	$2.00
1953	15,801,411	7.57	3.00
1954	28,454,002	6.55 *	1.75 *

* After two-for-one stock split.

The following excerpt from the August, 1955, issue of *Fortune* helps to explain the fairness of, and the reasons for, the plan:

For the next few months, or even years, Sperry Rand will be, inevitably, the simple sum of its parts, and Sperry Rand's sales, however big, will be made up of familiar items—Remington typewriters, tabulators, office furniture; Sperry Hydraulics, farm machinery, military electronics. The new balance sheet is also a two-plus-two proposition. Remington Rand, with its $50 million cash (equivalent to 45 per cent of its net worth) contributed some needed liquidity to Sperry, which was relatively low on cash at the time of the merger, but high on accounts receivable from the government ($27 million) and on its order backlog ($600 million). . . . From the viewpoint of the investor, of course, the question is how these combined sales and assets will be translated into earnings. In the last five years Rand's pretax earnings have averaged about 18 per cent of sales and 30 per cent of net worth. Sperry pretax earnings have averaged about 13 per cent of sales and a high 60 per cent of net worth (a potential hazard in renegotiation talks). On any analysis Rand until very recently has been something of a plodder whereas Sperry's problem has been the volatility of its business. The premise of the merger is that these weaknesses will cancel out, yielding a new balance of strength.[13]

The scientific method of valuation. The scientific method of valuation proceeds on the theory that a constituent has two distinct things to contribute to a consolidation, namely, assets and earning power. It entails (1) determining the capitalization of the consolidated company by capitalizing earnings, and (2) distributing the securities

[13] Copyright, 1955, by Time, Inc.

among the constituent companies according to a formula for evaluation of assets and earning power.

When the scientific plan is followed, the constituent companies may simply decide that all tangible assets shall be paid for with preferred stock at par and that the excess earning power shall be paid for in common stock. The excess earning power is usually called *intangible assets* or *goodwill* and is found by subtracting from the capitalized earning power the amount of tangible assets. Thus, if the tangible assets amount to $100,000 and the net earnings of a company amount to $25,000 a year, and 10 per cent is considered a fair rate at which to capitalize the earnings, the capitalized earnings will be $250,000 and the excess capitalized earnings will be $250,000 less the amount of tangible assets ($100,000), or $150,000. This company, then, would have $100,000 of preferred stock and $150,000 of common stock.

The scientific plan does not provide a hard and fast division of stock, but merely implies a principle, namely, that some allowance will be made for tangible assets in preferred stock and some allowance will be made for earning power in common stock. Just what allowance shall be made in any given case is a matter for the parties to negotiate. The reader must remember that there is no one scientific method.[14]

Funded indebtedness of constituents. The usual method of treating mortgages on constituent properties is to provide that all assets taken over shall be paid for in preferred stock at par, but that there shall be subtracted from the preferred stock which each constituent is to receive, an amount of preferred stock equal to the amount of funded indebtedness or mortgages of the constituent, or, as seems more equitable, equal to 125 per cent, or some other rate in excess of 100 per cent, of the mortgage indebtedness.

Sometimes it is possible to get bondholders to convert their bonds into stock before the consolidation is undertaken. Here attention must be given to the voting power which the bondholders will obtain through becoming stockholders. In the case of weak bonds, the bondholders may be willing to take the preferred stock or even the common stock of the stronger consolidated company in exchange for their holdings. If the outstanding bonds are callable, and there are sufficient funds to redeem them, their redemption may be undertaken as a step toward consolidation.

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[14] It is not necessary that both preferred and common stock shall be used. In recent years the use of common stock alone has been the more common practice. Such a practice avoids burdening the new firm with senior issues so that these can be used for later growth opportunities after the success of the combined companies has been demonstrated.

Preferred stock of constituents. Similarly, if any of the constituents has preferred stock outstanding, simplification of the corporate structure by redemption before the consolidation may be undertaken, provided the stock is callable.[15] Otherwise, the capitalization of the new company may have to include preferred stock with a dividend rate equal to that of the outstanding preferred to induce approval of the plan. In the bargaining process, however, it may be possible to induce the old preferred stockholders to accept new preferred stock with a lower dividend rate by offering them a bonus of common stock in the new corporation. An exchange of preferred for common of the new company is not likely to be accepted unless the ratios of exchange are profitable to the preferred stockholders.

New financing to effectuate plans. Frequently the consummation of a plan of consolidation or merger depends upon whether the new or surviving corporation is able to raise funds through the sale of securities or by borrowing. Thus, in connection with the merger of Sunray Oil Corporation and the Barnsdall Co., both corporations agreed that if the contemplated sale of securities were not consummated the agreement would be abandoned. The financing was carried through as planned and the merger became effective in 1950.[16]

Research Question

Select a merger or consolidation within the past few years and

(a) Determine the following information for each company prior to the consummation of the plan
Market price per share.
Book value of common stock per share.
Earnings per share for last five years.
Dividends per share for last five years.

(b) Explain why the acquiring company wanted the company it bought; or why the two companies wanted to consolidate.

(c) Do you think the exchange (i.e., the number of new shares received by the stockholders for their old shares) was fair? Why?

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15 Reclassification of stock in anticipation of consolidation or merger is discussed in Chapter 27.

16 To aid the Sunray Oil Corporation in financing the acquisition of Barnsdall Oil Company, investment bankers placed privately with institutions $80,000,000 in promissory notes and headed an underwriting group to purchase from the corporation and offer publicly 750,000 shares of common stock. In addition to its normal compensation as an underwriter of the common stock, the bankers also received compensation, according to the prospectus, for "services in bringing to the attention of the Corporation the opportunity of acquiring the capital stock of Barnsdall . . . in initiating and conducting the negotiations leading up to such purchase, in arranging for the necessary temporary financing involved in such purchase . . . and in evolving plans for the ultimate merger of Barnsdall into the Corporation. . . ."

Problem

1. It is proposed to consolidate Companies *A*, *B*, and *C* into a new corporation. The excess earnings expected to result from the consolidation are $600,000. The following facts are taken from the present financial statements:

Company	*A*	*B*	*C*
		(millions of dollars)	
Tangible assets	8	12	6
Fixed assets	10	15	7
Bonds	5	6	2
Preferred stock	5	7	4
Common stock	5	8	6
Surplus	3	4	1
Average earnings five years	1	1.5	1

   Assume that the average earnings of the new company would be increased by $1,500,000 as a result of economies. Suggest a plan of consolidation under which the new company would have a capitalization of $77,000,000.
2. How would your plan differ if you were proceeding by the bargain method? By the option method?

CHAPTER 24

Sale of Assets

Distinction between consolidation or merger and sale of assets. Instead of intercorporate relations being formed by consolidation or merger, the combination may come about through the sale of assets. Obviously, if a corporation sells out all of its assets to another corporation and then goes out of existence, the practical result is a merger. Similarly, if several companies sell out to a new company organized to take their assets, and then dissolve, the effect is a consolidation.

A number of points of difference between sale of assets and merger and consolidation may be mentioned to clarify the difference between these methods of creating intercorporate relations. (1) The principal distinction is a legal one. A sale of assets is essentially contractual, whereas a merger or consolidation is strictly statutory. However, in some states sales of assets are also governed by statute. (2) In a sale of assets, transfer of title is effected by deed or bill of sale; in a merger or consolidation title passes by execution of the merger or consolidation agreement. (3) A sale of the assets may include all of the assets of a corporation or part of them, such as all of the assets relating to one branch of the seller's business. In a merger or consolidation there is always a complete transfer of *all* the assets. (4) In a sale of assets the liabilities of the vendor are ordinarily not assumed by the purchaser, whereas in a merger or consolidation the liabilities of the merged or consolidated companies are automatically assumed by the survivor or consolidated company. (5) The sale of assets does not in itself destroy the entity of the selling corporation, whereas merger or consolidation does destroy the corporate entities of the companies merged or consolidated.

Uses of the sale of assets method. The sale of assets method of bringing about intercorporate relations is frequently used where consolida-

tion or merger is not legally practicable. For example, it may be used between several companies organized in different states whose laws are not favorable to interstate consolidation or merger. Or it may be used as a step toward consolidation or merger. Thus, if *A* Company is unable to merge with *B* Corporation because it is not organized in the same state as *B, A* may reincorporate under the laws of the same state as *B* as a step toward the merger. The reincorporation is effected through a sale of the assets of *A* Company to the new *A* Company. When a corporation wants to acquire a partnership or individual proprietorship, the combination is effected by a sale of assets because merger or consolidation can be used only where the parties are corporations.

Purposes other than intercorporate relations are also accomplished through a sale of assets. For example, if it is disadvantageous to continue as a corporation in a particular state because of excessive state taxes, the assets of the company may be sold to a new corporation organized in a more favorable state.

Nature of consideration. The consideration for a sale of assets may take the form of cash, of securities of the purchasing company, or of part cash and part securities of the purchasing corporation.

Where cash is given, the value of the purchasing company's securities need not be inquired into. This, of course, is an advantage. Moreover, the cash payment generally is more attractive than a stock payment. However, from the standpoint of the purchasing company there is the difficulty of raising the cash.

Frequently, the entire consideration for the sale is securities of the purchasing company. In such a case the shares received may be held by the selling company, in which event it becomes a holding company; or the shares when received may be distributed to the shareholders of the selling company, whereupon the latter company is dissolved.

Sometimes the sale is made for cash and securities of the purchasing corporation. The cash portion may be necessary to induce the sale, especially where the owners of the vendor corporation are eager to retire from business and want to diversify their investments. Payment of part of the consideration in stock reduces the amount of cash that would otherwise be necessary to effect the transaction. For example, De Walt, Inc. sold its property to American Machine & Foundry Co. for 115,000 shares of stock of the latter corporation and $655,000 in cash. Operation was continued by a new corporation of similar name, organized by the purchasing corporation as a wholly-owned subsidiary for the purpose. The old De Walt, Inc. stockholders received the proceeds of the sale in liquidating dividends and the corporation was dissolved.

Simplicity of sale of assets. From a legal standpoint, the consummation of an association by sale of assets is simpler than effecting a merger or consolidation. We may take the essential features of the Delaware statutes as a fair example of the legal steps required, and in order to bring out the advantages of the sale of assets over consolidation or merger proceedings we shall arrange the steps of both methods in parallel columns.

Consolidation or Merger	*Sale of Assets*
1. Action favorable to the proposed transaction by boards of directors of both companies.	1. Same as consolidation or merger.
2. Meeting of stockholders of both companies.	2. Meeting of stockholders of selling company only.
3. Approval of holders of two-thirds of stock of both companies.	3. Stockholders holding majority of selling company's stock must consent, unless charter requires larger proportion.
4. Agreement of consolidation or merger filed in office of Secretary of State and in county recorder's office.	4. Selling company delivers deeds and bills of sale to purchasing company.
5. Exchange of stock of consolidated or surviving company for that of constituents.	5. Exchange of stock or cash of purchasing company for assets of selling company Selling company distributes acquired stock or cash and is dissolved, or may continue in existence holding securities or other assets.[1]
6. Disgruntled minority stockholders in both companies may compel the consolidated or surviving company to buy out their interests for cash at assessed or appraisal value.	6. Same as consolidation or merger, but as to the selling company only.

To the purchasing corporation the sale of assets device is often preferable since it buys the assets only, and not the selling corporation's liabilities. In a merger, the purchaser or surviving corporation also takes on the seller's liabilities, and even the most careful investigation will not always turn up all possible liabilities. There may be some—for example, a possible tax deficiency—that even the selling corporation does not know about. The selling corporation, on the other hand, may prefer a merger since in this way the sellers will have all their profits taxed on a capital gains basis and will not be left with a corporation that still has to be wound up and dissolved.

Whenever a sale of assets, or a merger or consolidation is contemplated, income tax considerations enter into the picture. The general rule is that the sale or exchange of assets gives rise to a capital gain or loss to the party selling or exchanging the assets. However, certain provisions of the tax law permit the sale or exchange under the "tax-free reorganization" sections of the income tax law. In that case, the

[1] This latter method also preserves the name of the selling company.

capital gain or loss is postponed until the securities received in exchange for the assets are sold by the taxpayer.

Rights of stockholders. The statutes in some states specifically require that a certain proportion of the stockholders must consent to a sale of all the property of the corporation. The selling company must satisfy dissenting stockholders in accordance with the statutory provisions [2] and the terms of the agreement. In the absence of a statutory provision, corporations that are organized for private purposes and have no duty to the public have the right to convey all of their assets, only if *all* of the stockholders consent. An exception exists where a corporation is insolvent. In that case, the corporate assets can be sold with the consent of a majority of the stock if the best interests of the stockholders are served thereby and if the sale is not a fraud upon corporate creditors and not contrary to the charter, statutory, or by-law requirements.

If majority stockholders do not act pursuant to a statute, but sell the property of the corporation against the will of the minority holders, thereby effecting a practical dissolution of the company, the minority holders may, at their election, demand the market value of their stock at the date of the sale, or their proportional value of the proceeds; or they may follow the property into the hands of the purchaser and share in the profits arising from its use in the same ratio that they would have shared if the sale had not been made. If the transaction is made in bad faith, the sale may be set aside and the corporation rehabilitated, provided that the party asking for the rescission has not by his own delay permitted the rights of outsiders to intervene. Or, if application is made before the transaction is consummated, the minority may have an injunction to prevent the contemplated acts of the majority.

Rights of creditors. The only creditors with whom we need concern ourselves are those of the selling company. Ordinarily the creditors of the purchasing company are not affected, but they could be if there is some fraud in overvaluing the properties of the selling company and then issuing preferred claims on the purchasing company.

Specific liens on the property of the selling company are not displaced. At the same time the after-acquired clauses in the mortgages of the selling company become inoperative, for property acquired by

[2] These statutory rights are generally the same as those which apply to dissenting stockholders in the case of a merger or consolidation (see page 459). However, the statutes vary considerably and states that make provision for dissenting stockholders in the case of a merger or consolidation may not have a provision covering the sale of all the assets. Or they may have statutes covering dissent from a sale of all the assets and no provision covering dissenting stockholders where there is a lease of all the assets.

the purchasing company cannot be said to be after-acquired property of the selling company under the terms of the latter's mortgage.[3]

As a general rule, the purchasing corporation will not be liable for the debts of the selling corporation unless (1) there is an agreement, express or implied, to assume the debts of the selling corporation; (2) the purchasing corporation is found to be a mere continuation of the selling company; (3) the transaction is fraudulent; (4) a statute requires notice to creditors and the statute has not been followed.

If the selling company receives money to pay its debts, its creditors cannot subject the property in the hands of the purchaser to the payment of their claims, provided the purchaser is not liable for reasons mentioned under the general rule. But if the only consideration is capital stock of the purchasing corporation, and if the selling corporation, on account of the sale, has no property or assets of any kind that can be subjected to the payment of the selling corporation's debts, the purchasing corporation will be liable.

Most states have so-called "Bulk Sales" acts designed to protect creditors. Such laws require notice to the creditors of a business that the assets of that business are being sold. This gives the creditors a chance to assert and protect their claims. If the provisions of this law are complied with, then the buying corporation will not have to worry about these creditors' rights. But since bulk sales acts require publicity which the parties at the time may not desire, they often decide not to comply with the act. The buying corporation then has to rely on the warranty of the seller concerning the creditors.

Plan for sale of assets to effect a merger. When a corporation is sold for stock of the acquiring corporation, the deal is instigated and arranged in much the same manner as a merger or consolidation. The bargaining method is usually employed. The relative positions of the purchasing and selling companies are analyzed and the purchase price is worked out by applying the same principles as were discussed under consolidation and merger. Upon the consummation of the sale, the shares of the purchasing corporation received as consideration for the sale are usually distributed to the stockholders and the selling corporation is eventually dissolved. Thus, when Huron Milling Company sold assets having a book value of $9,000,000 to Hercules Powder Company in 1956, Huron shareholders received the securities issued in payment for the assets on the basis of 1 share of Hercules common for each 2.91 shares of Huron common. The Huron Milling Company held the Hercules common until a dividend was declared,

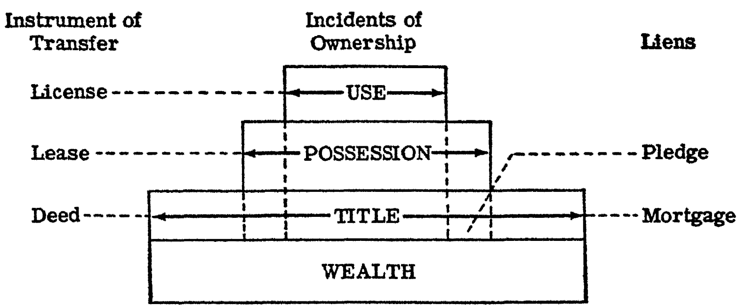
[3] This is generally the rule, though the selling company's mortgage might conceivably be so worded as to change this general rule.

the dividend being used to pay dissolution expenses. The Huron Milling Company was dissolved late in 1956.

Sometimes the corporate entity of the selling corporation is preserved, even though its assets are entirely distributed, in order to continue the right to the corporate name or to preserve valuable rights contained in the corporate charter. Occasionally the corporation is dissolved, but the name of the selling corporation is retained for selling purposes. In 1918, the Chevrolet Motor Co. sold all of its assets and business (except the company's holdings of General Motors stock) for a consideration of 282,684 shares of General Motors common stock. Thereupon each stockholder of the Chevrolet company received in General Motors stock shares equal to one-seventeenth of his respective holdings, and the Chevrolet company was completely dissolved. However, the acquired business became known as the Chevrolet Division of General Motors Corporation.

Intercorporate Relations Through Leases

What is a lease? Having discussed intercorporate relations formed through the sale of all the assets of one or more companies, we may now turn to leases. The incidents of ownership of property and the instruments used to convey them may be roughly indicated by the following diagram. Notice that each incident includes ownership of a lower degree.



Pledge transfers possession as well as title, whereas mortgage conveys legal title without possession.

A sale by deed transfers title or complete ownership which includes possession and the right to use; a lease transfers possession, and a license yields the right to use.[4]

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[4] Licenses might be included in intercorporate relations, but since they are used generally only by railroad companies in what are known as traffic agreements, we shall not consider them here.

A lease, then, is an instrument giving the right to possession of property to a tenant or lessee in exchange for rent to be paid to the landlord or lessor. At page 435 we discussed the lease arrangement where the acquisition of buildings was financed by institutional investors such as insurance companies and educational and charitable institutions. Here we are concerned with the lease of a corporation's entire assets.

Use of lease in intercorporate relations. The lease has been used extensively in the railroad industry as a method of intercorporate relations. During the period 1873 to 1893, when railroad systems were being formed by combining small railroads, the lease device was frequently employed. Since these contracts were for terms of 99 and more years, many of these old leases are still in operation.

Public utilities also made use of the device in their early period of expansion. However, the leasehold structure complicated the financing of growing organizations and when the holding company device became feasible, the lease method of intercorporate relations was dropped. Many of the companies that originally acquired local producing companies upon long-term leases got rid of the leases and acquired title to plants through the merger of the subsidiary lessor companies with some company owned by the lessee. Of course, this change could be made only where the lessee had acquired a controlling interest in the stock of the lessor company. The Public Service Electric & Gas Company, for example, pursued a policy of substituting ownership for leases in this way.

Industrial companies have rarely combined through the lease of assets, except where railroad properties were acquired. Mining companies have sometimes been leased for operation.

Rent. Corporate leases of the entire assets of a company usually include every form of tangible and intangible property, the possession and use of which are turned over to the lessee in exchange (1) for payment of all the lessor's operating expenses, such as taxes, salaries of officers, rent of offices, (2) for interest on the lessor's bonds, and (3) for a stipulated compensaton which may be (*a*) a flat annual sum, (*b*) a proportion of the gross revenue, (*c*) a proportion of the net earnings, or (*d*) a stipulated rate of dividends on the lessor's stock which in practice is usually paid directly to the lessor's stockholders by the lessee.

Tax treatment of payment by a corporate tenant (lessee) of a corporate landlord's (lessor's) income tax attributable to rental payments depends upon when the lease was made. If the lease was made before 1954, such payment is excluded from the landlord's income and is not deductible by the tenant. If the lease was made after 1953, however, the payment by the corporate tenant of the corporate land-

lord's tax on the rent is included in the landlord's income and deductible (normally) by the tenant.

The Federal income tax effects of dividends paid by the corporate tenant (lessee) to stockholders of the corporate landlord (lessor) are as follows: To the landlord (lessor), the amount of the dividends is considered rental income, just as if paid to it. To the tenant (lessee), the amount is treated as rent paid, that is, normally, a deductible business expense. To the stockholders of the landlord (lessor), the amount is considered as a dividend from the landlord. In other words, though the payment runs directly from tenant to landlord's stockholders, it is taxed as if it were rent paid to the landlord, and as a dividend paid by the landlord.

Since the lessor will usually have no income of its own, and since it is necessary that its corporate organization be kept alive (1) to protect the corporate franchise, (2) to see that the terms of the lease are being kept, and (3) to provide an official representation of the stockholders of the lessor in negotiations touching upon contemplated changes in the lease or upon matters of financing additions and the like, it is customary for the lessee to pay in addition to other rent some sum for "organization expenses."

Extra guarantees may be given to assure the payment of the stipulated rental. The $600,000 of rental to be paid annually to the Georgia R. R. & Banking Co. by the Louisville & Nashville and the Atlantic Coast Line is secured by various bonds that must have a clear market value of $1,000,000.

In leases of mining companies the clauses pertaining to rent usually provide that the lessee shall spend a certain amount of money per year for development purposes and shall pay to the lessor a certain sum per unit of ore taken from the ground. Thus the Tennessee Copper Co. has a lease on property in Polk County, Tennessee, the consideration for which is a royalty of $7.50 per ton of pure metallic copper produced from the ore and 15 cents per ton for all iron ore or other minerals sold from the leased land. Another arrangement, which is hardly to be recommended unless the lessee has demonstrated efficiency in its production methods, is to divide the net profits. Thus the Anaconda Copper Mining Co. pays to the Butte Copper & Zinc Co. one-half of the net profits derived from working the latter company's properties.

Some simple form of rent is always to be recommended in preference to complicated schemes of rent payments, since the latter are apt to result in controversy.[5]

[5] The lease of the Lehigh and Susquehanna R. R. to the Central of New Jersey (1871) provided for a rental equivalent to one-third of the gross receipts with a guaranteed minimum rental of $1,414,000 and a maximum of $2,043,000, plus one-

The effect of a lease. The usual effect of a lease, we have seen, is to make the lessee or tenant the active operating agent of the *property*—not of the lessor—and to give to the stockholders of the lessor, in exchange for their erstwhile more or less speculative interest in the profits of operation, a stipulated rate of income which is a debt against the lessee.

Who can make the lease. As in the case of intercorporate relations by sale of assets, the recipient of the property may take the property without getting the consent of its stockholders. That point seems quite evident. But the question of the rights of a stockholder of the prospective lessor is not quite so clear. To be sure, the question is frequently decided by statutes covering consents required and the rights of dissenting stockholders.[6] In the absence of such a statute, the rules are similar to those controlling a sale of assets. Except as a step toward liquidation (when the majority may lease for a reasonable time), the unanimous consent of the stockholders is necessary.

Rights of creditors. A tenant is not bound to pay the debts of the landlord, but a corporation cannot turn its property over without taking care of its creditors. The ordinary procedure is for the tenant to agree to pay the landlord's debts; this procedure prevents a disruption of the property or an interference with the lease by the landlord's creditors. Of course, all debts arising out of the operation of the property after the lease becomes effective are debts that belong solely to the tenant, and these include such debts as those arising from the negligent use of the property.

The tenant, likewise, agrees to pay the taxes; failure to do so not only injures the landlord but the tenant as well, since the property may be seized by the state for taxes in arrears.

Advantages of lease. Intercorporate leases have been used chiefly by railroads, and in that field they have presented certain distinct advantages. From the standpoint of the lessor, the lease gives the stockholders a certain guaranty of a fixed return and changes the nature of their claim from that of a stockholder to that of a bondholder. Their claim is that of a debt against the lessee, which debt if not paid will result in the lessee's loss of the property. In this sense, then, the debt is a fixed charge of the lessee, and, indeed, under the rules of accounting

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third of the gross receipts until such one-third amounted to an additional 7 per cent of the money expended by the lessor since December 31, 1882, in improving and extending its leased property. In 1926 all controversies under the lease were settled and an annual rental was fixed at $2,267,801 together with an additional amount based on additions and betterments made subsequent to 1926. In 1944, as a step toward subleasing the property, another settlement of differences had to be made because of varying interpretations of the original lease and subsequent agreements.

[6] See note 2.

of the Interstate Commerce Commission, is grouped with the bond interest of the tenant in its income statement.[7]

From the standpoint of the lessee, the lease gives the company control of property, usually of great strategic value, which could not be acquired in any other way. Thus, in 1868 the Delaware, Lackawanna & Western obtained a lease of the property of the Morris & Essex, which property has been likened to the neck of a bottle emptying the traffic of the former company's road into the great seaport of New York.[8]

In general, the lease provides a simple method of forming intercorporate relations which does not require the issuing of any securities or the raising of any funds.

Another advantage of the lease form of combination is that the lease may become valuable and yield a profit to the corporation upon a sale or assignment thereof. A combination effected by a lease has the further advantage of being easily dismantled if the arrangement proves unprofitable. At the expiration of the lease, the leased property is simply returned to the lessor. To be sure, if the lessee has acquired a controlling interest in the lessor through stock ownership, the dismantling may involve a sale of the stock upon the reversion of the leased property to the lessor.

A lease may sometimes perform a function that could not very well be performed by any other device. An illustration of an extraordinary situation solved by a lease is that of the lease to a Texas company of all the properties of the Missouri, Kansas & Texas Railroad Company lying within the State of Texas. This lease was made in compliance with an agreement with the State of Texas looking to the enforcement of its statutes prohibiting the control of railroad property within the State of Texas by other than Texas corporations. All of the stock of the Texas company is owned by the Missouri, Kansas & Texas.

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[7] It is interesting to note that if company *A* wishes to control company *B*, it may do so by lease, or by acquiring the stock of company *B* and issuing to the stockholders of company *B* in place of their stock, collateral trust bonds secured by the acquired stock. This was the method followed, for example, by the Rock Island Railroad, a non-operating company, in getting control of the stock of the Rock Island Railway. (W. Z. Ripley, *Railroads, Finance and Organization* [New York: Longmans, Green & Co., 1915], page 527). In the one case rent is to be paid for a lease; in the other interest is to be paid on collateral trust bonds. In the one case the original stockholders of the controlled property retain their stock; in the other they exchange them for bonds secured by that stock. It would seem that the lease is a better arrangement, since if the controlling company does not meet its obligation, the lease can simply be declared broken and the property recovered, while in the case of the collateral trust bonds, the pledged stock will have to be recovered through foreclosure proceedings, unless, of course, the debtor company agrees to a voluntary release.

[8] The last rental dividend payment on this lease was made in 1942 when the Morris & Essex R.R. Co. was merged into the Delaware, Lackawanna & Western.

Disadvantages of the lease. Why is the lease not used more generally? In the first place, the maintenance of the lessor company as a separate entity means additional taxes and duplicate reports to governmental bodies. In the second place, it establishes a relation of somewhat "unstable equilibrium," to borrow a phrase from physics. There is always the problem of *meum* and *tuum*. Instead of a single interest in the property, there are always two interests to be considered—that of the tenant, and the ultimate interest of the landlord in the reversion of the possession. If the lease is not very carefully drawn, litigation is invited and the development of the property is retarded by the uncertainties regarding mutual rights and liabilities. Moreover, unless the lease provides some equitable method of financing additions and improvements, these will probably not be undertaken by the tenant without compensation, since the possession and title to them will revert to the landlord on the termination of the lease.

Flexibility of leases. A great many leases, especially of railroad properties and real estate in business districts, are made for 99 years, and a few are made for a period of 999 years. Where the rental is fixed in such long leases, injustice may be done to one party or to the other. Thus, without fault on the part of the lessee, the earnings may diminish to an amount less than the rentals. A parent may get rid of a burdensome subsidiary, but the burden of a lease is a contractual obligation that cannot readily be set aside.

On the other hand, conditions may change as they did during and after the war, and the fixed rental, to the injury of the lessor, may lose its purchasing power.

It would seem to be better, therefore, to make the term of the lease rather short and to make, if desired, some provision for renewals on an adjusted basis.

Quite often a lease will give the lessee an option to purchase the properties. The lease agreement between the St. Paul Bridge & Terminal Ry. Co. and the Chicago Great Western Railway Company executed in 1934 for a 99-year term with rentals of $100,000 a year had such a provision. In 1941 the lessee purchased the property for $1,500,000 from the proceeds of a Reconstruction Finance Corporation loan.

Financing additions and improvements. Under the common law of leases, any additions or improvements affixed to the property by the tenant become the property of the landlord at the expiration of the lease. Thus it would seem that in the absence of a special provision in the lease, such improvements as the electrification of a leased steam railroad would only temporarily benefit the company that paid for them—the lessee—and would finally at the expiration of the lease belong, without compensation, to the landlord. This was just the

situation in respect to many old leases. From one standpoint this apparent injustice would not seem to bear heavily on the lessee. The lease, we may say, is for 999 years, and a given improvement costing $1,000,000 is contemplated. Shall the fact that in 999 years the $1,000,000 is to be turned over to the landlord deter the lessee from making improvements? What will be the value of a present investment of $1,000,000 a thousand years from now? The lessee would have to earn each year only a very small sum above the interest on the $1,000,000 to accumulate a sum of $1,000,000 one thousand years hence.

But there is always the hazard of losing the property before the expiration of the contract period. The lessee may run into hard times, find it impossible to pay the rental, and have to give up the property. The risk is too great. And, moreover, there is a bit of psychology involved. Why put money into other people's property?

The modern method of financing such improvements is to cause the landlord company to pay for them with its own securities. This method is eminently fair, for as long as the lessee uses the improvements, it pays rent for them by paying the interest on the landlord's bonds or the dividends on the stock that was issued to pay for the property, whereas the permanent ownership and the capital obligation both belong to the landlord.

Maintenance of leased properties. The common law of leases provides that the tenant must make repairs. But in corporate leases involving large and valuable properties the maintenance of the property is specially provided for. The tenant is required to keep the property properly and adequately repaired (some of the older leases naïvely provided that the tenant was not to "make any discrimination" between its own property and that of its landlord), to keep it properly insured, and to permit the landlord's officers to make tours of inspection.

Return of leased premises. The lease usually provides that an inventory shall be taken at the inception of the lease and that all properties shall be returned in kind or its equivalent. The returned property, of course, must include all improvements and additions.

Cancellation of lease. The lease usually provides that if the rent is not paid, the lessor may retake the property. Days of grace—from thirty days to six months—are given and notice of intention to retake is required to be sent to the lessee in writing. Moreover, the lease may require that a notice addressed to the stockholders of the lessee must be published in several newspapers.

Usually a default will not take place unless the lessee is insolvent and a receiver has been appointed. Since the appointment of a receiver

places the property in the control of an equity court, the landlord must apply to the court for permission to retake the property.

Control of lessor's subsidiaries. When a lease is made, it generally carries with it control of all the landlord's properties. The lease usually provides that during the term of the lease the lessee may vote the stock of the lessor's subsidiaries and thus effectually control them. The lessee usually assumes the leases made by the lessor of other companies' properties.

Treatment of lessor's bonds maturing during the term of the lease. If the lessor had issued bonds before the date of the lease, these bonds will have a claim on the property superior to that of the lessee's in case it becomes necessary to foreclose the lien securing the bonds. It is for that reason that the lessee always, in modern leases, agrees to pay interest on the outstanding bonds of the lessor directly, instead of paying a flat sum to the lessor and permitting it to pay its own bondholders. For much the same reason the lessee is interested in the payment or refunding of bonds that mature during the term of the lease, for if the obligation to pay them is not met, the bondholders may foreclose this mortgage and thus get control of the property away from the lessee. The lease will therefore provide that the lessor will issue other securities to be used by the lessee in refunding the lessor's bonds at maturity.

Leases coupled with stock ownership. It is quite usual to find that leases are coupled with stock ownership. Sometimes the lease antedates the acquisition of the stock of the leased properties and sometimes the acquisition of the stock antedates the lease. Thus a lease may be about to expire; since the stockholders of the leased property have been receiving a fixed return on their holdings, they will know very little about the true value of their company; the market value of their stock will not reflect any change in the value of their property but will be fixed by the dividends paid by the lessee. But these dividends may have been determined years before, when the earnings were small. When the expiration of the lease is imminent, the stockholders will make expert inquiry into the value of their properties and will probably demand higher dividends. It is therefore expedient for the lessee gradually to buy in the stock of its lessor before such an expert valuation reveals the true value of the property and of the stock.

Where a company is controlled by stock ownership, a lease may subsequently be made to bind the intercorporate relations more closely and to prevent a disruption through concerted action on the part of outside stockholders of the lessor.

Problems

1. The owners of Irwin Corporation, a closely held company, wish to wind up the business and retire. The White Company is interested in acquiring the business, and both a purchase of the corporation's assets and a purchase of the stock of the corporation have been proposed. The balance sheet of the Irwin Corporation is as follows:

Cash	$ 40,000	Accounts payable	$ 10,000
Accounts receivable	10,000	Capital stock	100,000
Inventory	50,000	Surplus	70,000
Plant and equipment ($100,000 less $20,000 depreciation)	80,000		
	$180,000		$180,000

Proposal 1 is to purchase the assets for $150,000; proposal 2 is to purchase all the stock for $190,000.

(a) Which will cost the White Company more, proposal 1 or 2?
(b) Without calculating the tax, tell what tax the Irwin Corporation and its stockholders will have to pay (1) if there is a sale of assets, (2) if there is a sale of stock.
(c) Would it make any difference to the White Company whether it bought the assets or the stock?

2. Mr. Jones owns a garage and gas station. The Smith Chain wants to acquire it on a lease basis to add to those they already own or run. They do not have the cash to buy the Jones place outright. Mr. Jones' building and equipment are new. It is located in a fast-growing community. The building should last 50 years. Mr. Jones wants a 30-year lease, the tenant to pay all expenses and taxes and make repairs. The rental is to be fixed at 8 per cent return on the appraised value of the property.

(a) Criticize the lease from either the lessee's or lessor's point of view.
(b) Can you suggest a fairer basis for fixing the rental?
(c) Would the Smith Chain experience any difficulty in using the lease as security for short-term bank loans? For long-term loans? Explain.

CHAPTER 25

Holding Companies

Definition. Any company that holds the stocks of other corporations may be called a holding company. However, the term is usually restricted to two types of organizations, pure holding companies and mixed holding companies. A *pure holding company* is a non-operating company organized for the purpose of investing its capital in the stocks of other companies, the affairs of which it undertakes to direct or administer. In the industrial field the Standard Oil Company (New Jersey) is an example of such a holding company. They are more numerous in the public utility industry [1] where Electric Bond & Share Co. and American Cable & Radio Corporation are typical. A holding company that is itself an operating company is called a *mixed holding company*. A good example of this type is General Motors Corporation which, in addition to being an operating company in the automotive industry, controls over 25 foreign-chartered companies through stock ownership.

Below is a diagram of a holding company structure.

The top holding company, designated *A*, is at the summit of the entire organization. It directly controls an intermediate holding company, *B*, and a service company, *C*. The holding company *B* is an operating company controlling an aggregate of three operating companies, each of which conducts a separate business in an allied line, or a separate division, which is necessary for the organization. Service company *C* performs the legal, accounting, and engineering functions for the entire system.

Any company owned or controlled by another to the extent that it is a mere instrument to carry out the orders of the owning com-

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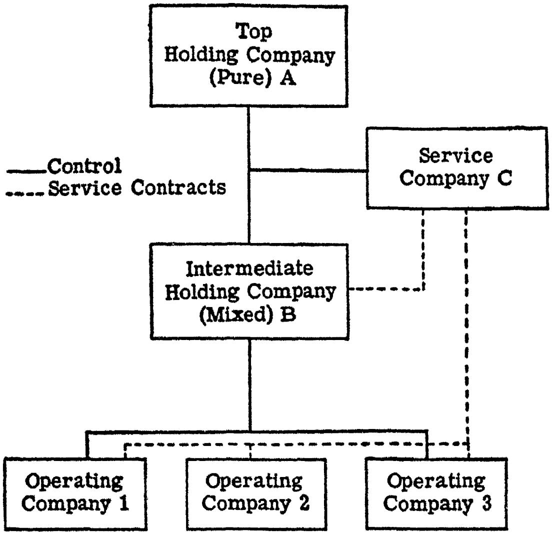
[1] For definition of a holding company under the Public Utility Holding Company Act of 1935, see page 498.

pany is called a *subsidiary*. The owning company itself is usually called the *parent*.



Right of a corporation to hold stocks of another. A corporation is a creature of the state under the laws of which it is organized. Its powers are those derived from the state's corporation laws and from its own charter. It has no inherent right to hold the stocks of other companies and the statutes of the various states vary greatly in the extent to which they grant this right. Some are very liberal and permit it without limitation; others authorize it only under certain restrictive conditions.

Before 1888 the generally accepted and prevailing opinion concerning purchase of stock of one corporation by another was that the practice amounted to engaging in a business other than that authorized by the charter of the purchasing company. Such purchases were considered, therefore, to be *ultra vires* unless, under all the circumstances, the acquisition of stock was a necessary and reasonable means to carry out the corporate objectives or was one which under the statute it might accomplish. For example, under extraordinary circumstances a corporation could acquire shares of another as security for, or in satisfaction of, a valid debt. In such cases the holding was merely incidental and temporary pending conversion of the securities into cash or their redemption.

In 1888 New Jersey changed the restrictive rule by legislative enactment. Although its action was contrary to the trend of opinion at the time, many states promptly followed its lead since the compe-

tition among them in the issuance of corporate charters was keen. New Jersey and Delaware, being the earliest to liberalize their laws, became the states in which many of the great holding companies such as Standard Oil, United States Steel, and the American Tobacco Company, were formed.

The law today in almost all states is that corporations may acquire stock of other corporations. State as well as Federal anti-trust laws limit this power to the extent that acquisitions that tend to lessen competition or restrain trade are forbidden. In some states, this power must be expressed in the corporate charter. For example, in New York, if authorized by its charter, the corporation may buy the shares of any other corporation. But if there is no provision in the charter, the corporation may only buy stock of corporations engaged in the same or similar business or whose products or operations are necessary or useful to the corporation buying the stock. It is customary, therefore, whenever permitted by law, to include in the charter of a new corporation a provision to the effect that "this corporation shall have the power to acquire, hold and dispose of stocks, bonds and other evidences of indebtedness of other corporations."

Development of holding companies. The earliest use of the holding company device, before the corporation laws generally permitted corporations to acquire stocks in other companies, occurred in connection with the development of railroad "systems" through the consolidation of numerous short lines. Where stock in other corporations was acquired in this process, it was done through power granted by special acts of the legislatures. In recent years, control of the railroads by the Interstate Commerce Commission has tended to restrict the combination of established systems under holding company arrangements.

In the industrial field, as we have already seen, the holding company device superseded the trusts which created the great combinations that were prosecuted as monopolies. Since then, the holding company device has been used in the industrial field principally to operate different parts of a business as separate corporate entities. The industrial combinations have not generally represented great "systems" such as developed in the public utility field during the 1920's.

Before 1914, especially in the electric power industry, small local companies provided limited areas with public utility services. These local companies were later combined into great "systems" or networks of services principally by the use of the holding company device. Many holding company systems, especially in the electric and gas utility fields in the 1920's, became extensive empires of heterogeneous operating companies with no functional, geographic, or

economic relationships and with numerous useless intermediate holding companies. The combinations were neither incidental, appropriate nor reasonably necessary for operations of the basic producing components of the system. Most of these resulted from promotion schemes of persons motivated solely by desire for huge concentrations of wealth and power and without regard for public benefits or operating efficiencies of the underlying companies. The existence of none of these wasteful and uneconomic units was justified. Legislation was necessary to overcome the bad practices and their elimination is now well under way.

Though considerable attention will be given in this chapter to the abuses that prevailed especially in the public utility field before corrective legislation was enacted, the student must not get the impression that the holding company today is an iniquitous device. It can, and does, serve many useful purposes, as we shall presently see.

Stock necessary for control. Logically, it would seem that under ordinary circumstances a corporation must hold at least a majority of the stock of a subsidiary to assure control. But very often a much smaller percentage will suffice.[2] In any case, domination of the board of directors and management, however obtained, is the essential element of control. Frequently it has been achieved simply by buying considerably less than half of the voting stock of an existing corporation from its directors, and at the same time obtaining their resignations in order to replace them with persons amenable to the will of the purchaser. If the same end were sought through accumulation of a majority of shares from many holders it might be impossible or too costly to achieve. A classic example of an attempt to secure control of a corporation by purchase of a majority of its shares concerns the Northern Pacific Railway. In 1901, E. H. Harriman and a group of New York bankers tried to wrest control of the road from J. J. Hill. They entered into a wild scramble for shares which eventually led to their combining forces rather than to the victory of either over the other.[3]

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[2] The respective holding companies which owned the stocks of the following utilities achieved control through ownership of the relatively small percentage of voting stock indicated after the names of the subsidiaries: Pacific Gas and Electric Company, 17.9 per cent; Detroit Edison Company, 35.8 per cent; Central Hudson Gas and Electric Company, 29.7 per cent. Tenth Annual Report of the SEC, 1944, note 4, page 84. See note 8 at page 491.

[3] This contest has frequently been described. The outline of events is as follows: The total capital stock outstanding of the Northern Pacific in 1901 was $80,000,000 of common stock, and $75,000,000 of redeemable preferred, both classes having voting power. In an effort to obtain control of the company, E. H. Harriman, backed by Kuhn, Loeb & Co., bankers, bought shares until he owned $37,000,000 of the common and $42,000,000 of the preferred, or a total of $79,000,000, which gave him more than a majority interest. J. J. Hill, who was originally in control of the com-

A good example [4] of transfer of control of a company by acquisition of less than one-third of the outstanding stock is that of the purchase of the shares of Western Union Telegraph Company by the American Telephone and Telegraph Company. Without any publicity as to details at the time of transfer, a large, but unspecified, minority interest was purchased by AT&T from the Gould family. It was subsequently revealed that the transfer involved 300,000 of a total of 1,000,000 shares. The immediate result of the sale was a change in the management of Western Union. Ten new directors were elected, and although it was understood that the Goulds also tendered resignations, two of them remained on the new board. By agreement with the Department of Justice, the American Telephone and Telegraph Company later divested itself of these share holdings.

pany, and who was backed by J. P. Morgan & Co., purchased stock additional to his relatively small original holdings until he owned $42,000,000 of the common stock and $29,000,000 of the preferred stock, giving him a total of $71,000,000. As a result of this contest the price of the stock shot up to $1,000 a share.

Hill let it be rumored that the board of directors would exercise the option of the corporation to redeem the preferred. If the corporation were to exercise the option and redeem the preferred, the road would remain under the control of Hill because he had a clear majority of the common. Although the right of redemption did not arise under the terms of the stock until the succeeding year, and although a meeting of stockholders was scheduled to be held in the meantime, Hill hinted that the meeting would be postponed till the preferred stock could be redeemed. Had these things in fact been done, Harriman's majority holding would have been changed into a minority of the outstanding common stock.

Evidently both Hill and Harriman lost their nerve and decided to combine forces. They formed the Northern Securities Company, a holding company, to hold the stock of Northern Pacific and Great Northern, a majority of which was owned by Hill and Harriman. Harriman owned about $80,000,000 of the Northern Pacific and about $50,000,000 of the Great Northern; Hill owned about $70,000,000 of the Northern Pacific and $150,000,000 of the Great Northern. The shares of these two companies were exchanged for shares of Northern Securities Company. Harriman received 13/35 of the shares of the Northern Securities Company, and Hill 22/35.

Everything worked well until the government brought suit for dissolution of the Northern Securities Company under the Sherman Anti-Trust Act, contending that the combination eliminated competition between two theretofore competing roads. The government was successful in its suit, the court ordering dissolution of the Northern Securities Company.

When a corporation is dissolved each shareholder is entitled to a pro rata share of the assets of the dissolved corporation; Hill claimed that he should receive 22/35 of the stock of Northern Pacific and 22/35 of the stock of Great Northern. If this had been done, Hill would have gained control of both roads. Harriman claimed that the agreement to form Northern Securities Company was void from the beginning and, therefore, the parties should be placed in status quo each receiving the number of shares he had put into Northern Securities Company. Hill's contention was that the agreement was not void, but merely that the action of the Northern Securities Company in holding stock of competing lines was illegal. He therefore argued that the contract was not void from the beginning and the shareholders should receive a pro rata share of the assets of the dissolved corporation. Hill was sustained and Harriman lost control of the Northern Pacific. Harriman v. Northern Securities, (1905) 197 U. S. 244, 25 S. Ct. 493.

[4] The histories of United Corporation in the utility field and of Alleghany Corporation in the railroad field are also of interest as examples.

Acquisition of control through ownership. One company may secure ownership control over another in either of two ways.[5] It may purchase a controlling interest in an existing company or it may form a new company and retain a controlling interest. Purchase of closely held concerns may be paid for in cash or by exchange of stock of the purchasing company for shares of the company to be bought. Acquisition of shares of a widely held corporation may be achieved by buying them in the securities markets. Where an exchange of shares is not feasible, cash must be raised by the holding company. The most common means used to secure funds with which to purchase or to get capital for a new enterprise is for the prospective parent company to float securities of its own.[6]

Pyramiding. The term "pyramiding" refers to the technique by which a few individuals who control a top holding company gain control over vast properties with an investment of relatively small sums in each of a number of interrelated companies. The pyramided structure is made up of a holding company at the apex and various levels of intermediate holding and operating companies. The picture of the structure can be seen from the following simplified explanation of the pyramiding technique.

For purposes of illustration let us assume a pyramided structure consisting of three levels—a top holding company, intermediate holding companies, and an unspecified number of operating companies. The top holding company procures the bulk of its funds for purposes of investment in other companies by the issuance and sale of its own non-voting securities to the public. The voting common stock, which is a relatively small percentage of the total capitalization of the top holding company, is purchased by the promoters and key management personnel. This assures their control of all of the funds. The moneys available to this company from the public sale of the non-voting stock are then invested in the voting common stocks of the intermediate holding companies. The amount of these investments in the intermediate companies will vary from 51 per cent of the voting common stock to a mere fraction of that figure, but will be sufficient to assure control of these subsidiary companies. The greater part of the intermediate holding companies' funds are likewise obtained from the public sale of non-voting securities. However, the public also holds some voting common stock. For the most part it is ineffectual for

[5] There are forms of control of business property other than through ownership, such as by lease. The lease method was discussed in the preceding chapter.

[6] It has been estimated that in the period 1924–1930 public utility companies, which usually used the method described above, issued some $5,000,000,000 of securities most of which were used to finance the purchase of utility operating companies Senate Report Number 621, 74th Congress, 1st Session, 1935, page 15. Super-holding companies used the same method to get cash with which to buy holding companies.

purposes of control because it is widely distributed to many small holders who are neither interested in control over management nor able to combine effectively to elect directors of their own choosing.[7] The intermediate holding companies invest the vast funds available in *their* coffers in the voting common stocks of operating companies. These operating companies also are financed principally by the sale of various classes of securities to the public. In each case the primary concern of the particular holding company is to secure only so much of the voting stock of the companies comprising the system as is necessary to give it dominance in control.

Thus, by means of small investments in companies that have been provided with funds primarily by the public sale of securities, persons in control of the top holding company were able to dictate the policies of the entire system. Their influence permeated the interrelated companies and greatly exceeded that of the thousands of investor-owners, who exercised practically no ownership powers. A computation of the total value of all controlled properties and of the investment made by those owning the voting stock of the top holding company sometimes revealed that the destinies of a vast empire, to which the public entrusted enormous sums, were controlled by men owning not more than 2 or 3 per cent of the value of the system's properties.[8]

Pyramiding cannot take place in the public utility field today because of the Public Utility Holding Company Act of 1935.

Viewpoint of discussion of advantages of holding companies. Most advantages claimed for combinations that eliminate competition and permit large scale production apply to holding companies. There are, however, certain important advantages peculiar to the holding company system, as compared with other forms of business combinations. Before we consider the most important of these it is necessary to point out the viewpoint taken in presenting them. First, we have assumed that the holding company is a well-organized system, free from abuses, and competently operated and administered. Second, we have recognized that in the holding company form of intercorporate relations there may be many conflicting and adverse interests. There are the interests of the holding company itself and of its subsidiaries as well as of the stockholders, directors, and officers of each of them. In addition, there are the interests of consumers and the general public. What constitutes an advantage to one group may well be a distinct disadvantage to another. The advantages listed below are those accruing to the majority of all the interests involved. There is not sufficient space to

[7] See page 67.

[8] Standard Gas and Electric pyramided until an investment of less than $1,000,000 controlled approximately $370,000,000 of invested funds. Tenth Annual Report of the SEC, note 6, page 86. See also note 2 at page 488.

permit discussion of any adverse effects upon any particular group or interest.

Advantages arise in many instances because subsidiaries can and do serve certain well-defined purposes. Thus, indirectly there is provided in the following list of advantages an enumeration of the reasons why subsidiaries are formed and the various purposes which they serve.

Advantages of holding companies. The most important advantages are:

1. *Flexibility and facility of formation.* The holding company relationship is perhaps the least troublesome to create of all the forms of combination. No consent of stockholders of either the holding company or of the subsidiary is required. Difficulties in getting stockholder agreement to a plan of merger or consolidation, of having to deal with recalcitrant minorities, or of determining control responsibilities between absorbed personnel of merged and consolidated companies, are avoided. The history of the formation of many such companies indicates that combinations formed in this manner have been remarkably free from annoying and difficult litigation by stockholders and creditors.

Through the use of collateral trust bonds secured by the stock of the subsidiaries it is possible for a parent company to acquire additional companies for the system without the outlay of its own treasury cash. Of course, this very facility is one of the reasons why abuses in holding company finances became prevalent.

2. *Economy and efficiency of operations.* A well integrated, competently managed organization, free from abuses can effect many operational and administrative economies. It can employ high priced experts for advising subsidiaries, furnish them financial assistance, effect savings in quantity purchasing, and the like. Some economies available to combinations formed by merger or consolidation, however, cannot be effectuated by holding company systems. For example, the integration into one entity by merger or consolidation permits elimination of duplicate facilities, activities, and personnel; a holding company, because of the nature of its composition, cannot achieve these economies.

Sometimes greater efficiency is achieved by placing a number of similar companies, functionally or geographically related, under a sub-holding company. Under its operational direction, and serviced by it, such a unit may function almost autonomously.

3. *Avoidance of onerous legislation or legal impediments.* Each state is competent to determine the qualifications and conditions for doing business within its borders for corporations chartered by it or by other states. They sometimes enact legislation onerous to, or

adverse to the interests of, foreign corporations, e.g., foreign corporations may have to pay higher taxes. By purchasing a going business of that state or by forming a corporation under its laws as a subsidiary to carry on the local activities, a holding company may often circumvent the discriminatory legislation.

Under some circumstances, it may be desirable to organize a subsidiary for some phase of business not provided for in the parent's charter and thus avoid the requirements for charter amendment. Another reason for incorporating a subsidiary is that the type of activity to be engaged in may require incorporation under a special act (e.g., insurance, banking, transportation).

In industries that are regulated to some extent by local authorities, there may be considerable advantage in having a local subsidiary to deal with such authorities. The figures and other details of activities that have to be reported to the regulatory body will then be the figures of the small subsidiary rather than of one large company.

4. *Avoidance of business risks and litigation.* Activities of a business enterprise may be departmentalized into many separate functions, such as parts manufacture or processing of materials, assembly, domestic and foreign sales, financing, and advertising. Separate subsidiaries may be formed or purchased to undertake any one or more of these activities, thus segregating business risks. A further advantage of this form of departmentalization is that uneconomic units may be disposed of or liquidated more easily than an integrated function.

Research or experimental activities may be made the responsibility of a subsidiary to segregate financially hazardous developmental and promotional activities for new products.

Corporations that possess valuable trade secrets are obliged to take considerable care and use extraordinary precautions to preserve secrecy. Once lost through carelessness or discovery of the secret, there is no protection available. Thus, a subsidiary may be entrusted with utilizing the trade secret because personnel and facilities necessary for its use can be concentrated into a smaller unit. Fewer persons need be informed concerning it, thereby lessening the chance of wilful or inadvertent disclosure.

A separate company often is used to tap a class market not exploited by the parent corporation. Thus, it may produce and market an inferior or cheaper product than that of the senior firm under a separate trade name or label. In this way the established lines and the reputation of the holding company remain disassociated from the lower grade articles or services. Conversely, a company known for an inexpensive line of goods may form a separate company to put out a quality product so as not to associate the new line with its name.

Where a useful purpose can be served, several competing corpora-

tions sometimes create a joint subsidiary. Such a subsidiary may exist to hold patents [9] and to issue licenses to components of the holding company systems or even to third persons. Another may administer joint properties, such as a railway terminal.[10]

Some holding companies find it advantageous to use subsidiaries to handle special technical services such as engineering, financial, construction, transportation, insurance, or stock purchase and profit-sharing activities. Or they may handle matters likely to involve litigation,[11] or matters temporary in nature, but likely to be prolonged over a period of years. Such companies may either serve the purpose of avoiding risks or facilitating the use of a service by components of the entire system.

5. *Preservation of existing benefits.* A wholly independent company, well known locally, and possessing valuable trade names and goodwill within a regional area, may become a subsidiary of another corporation. In order to keep intact its reputation, goodwill, and "local" character, the subsidiary will often be allowed to retain its officer personnel and the local citizens serving as directors. Criticism against foreign "absentee" ownership is thus minimized or prevented. By permitting former employees to keep their titles and principal responsibilities, morale and loyalty are encouraged. When competing companies are brought under common ownership they are occasionally retained without merger or consolidation to keep the competitive spirit alive and to increase efficiency.

Disadvantages of holding companies. Just as the holding company form of organization shares with other business combinations certain advantages while presenting some benefits peculiar to itself, it possesses some of the disadvantages of those other combinations plus a few of its own. The most important of the holding company disadvantages are:

1. *Expenses and costs.* The cost of special corporate records, directors' meetings and the like must be taken into consideration. Such expenses are relatively heaviest when the separately incorporated unit is small, and the expenses diminish in importance as the unit becomes larger. When the unit is large, directors' meetings, accounting and other reports represent necessary activities that would find their

[9] Great care must be taken to avoid falling under the provisions of the anti-trust laws in such cases. Patent pools are illegal.

[10] For example, the Union Depot in Houston, Texas, is owned by The Houston Belt & Terminal Railway Company which in turn is owned (25 per cent each) by (1) The Beaumont, Sour Lake & Western, (2) the St. Louis, Brownsville & Mexico, (3) the Gulf, Colorado & Santa Fe, and (4) the Rock Island System. For other uses of joint subsidiaries, see Ch. 22, p. 442.

[11] Extensive properties affected by the terms of a will, for instance, may be isolated by turning them over to a separate company pending settlement of questions that may arise during probate.

counterparts in divisional staff meetings and departmental reports in an integrated company. The salary of subsidiaries' officers cannot be considered an extra cost unless the officers do not perform operating functions commensurate with their compensation.

Preservation of separate corporate existences of subsidiaries results in the loss of some benefits available to other forms of combination. For example, goodwill earned by the principal companies is not attributed by the public to subsidiaries, which, using their own corporate names, are not known to be part of the system. Advertising and marketing efforts tend to be dissipated without benefiting all components of the structure.

2. *Complexity of structure.* There is a tendency for the structure to become complex. Before the Public Utility Holding Company Act of 1935 was passed, the structure of the great holding company systems in the utility field was exceedingly complex. The capital structures and intercorporate relationships of some empires became deplorably complicated. This opened the way for frauds, excesses, and abuses and resulted in economic losses because of the difficulties of supervision and management. An unsound and unnecessarily complicated capital structure of subsidiaries and of systems as a whole is usually accompanied by unsoundness of the financial structure. Slight losses by dependent concerns meant, in some cases, tremendous losses for holding companies with defaults, cessation of dividends, and even bankruptcy as a natural consequence. By their attempts to overcome losses and defer the consequences of decreased earnings, holding companies have sometimes been guilty of abusive and improper practices which in turn have weakened financial soundness of dependent companies and the system. We shall consider this further below. The possibilities of great changes in holding company incomes encourage speculative interest in their stocks and make them volatile.

Tax factors in operating a holding company. In some respects the operation of a business through several subsidiaries may cause a greater tax burden than if the business were operated through a single corporation. But under some circumstances it can also result in tax savings. If a holding company owns at least 80 per cent of the stock of a subsidiary, it may file a consolidated return with that subsidiary. Any number of corporations may join in filing a consolidated return, assuming one is the parent corporation and all the others are at least 80 per cent owned. On a consolidated return the losses of one corporation may be used to offset the profits of another. However, there is an additional tax of 2 per cent imposed on corporations filing a consolidated return.

The affiliated companies may file separately. In that case, losses of one cannot be offset against the profits of another. But each cor-

poration is entitled to a $25,000 surtax exemption. Thus, at 1958 corporate tax rates, a corporation with $100,000 income would pay $45,400 in taxes. If this business could be split into four corporations, each with an income of $25,000, the total tax bill would be only $30,000.

If separate returns are filed, the parent must pay a tax on 15 per cent of the dividends it receives from subsidiaries. No such tax need be paid if a consolidated return is filed.

State taxes vary even more with individual circumstances. Usually, the more corporations are utilized, the more state taxes will have to be paid (franchise taxes, income taxes, etc.). However, subsidiaries may be able to adapt themselves to local methods of taxation. For example, when a state taxes a foreign corporation on a fraction of its capital equal to the fraction that sales within that state bear to total sales, a single corporation may have to pay a substantial amount even though the actual property used in the state is negligible. A subsidiary might be subject to a smaller and more equitable tax based on the property it owns within that state. Thus, a number of subsidiaries designed to meet the peculiarities of local corporate and business taxes may effect considerable savings.

Susceptibility of the holding company to abuse. The holding company form of combination is peculiarly susceptible to the introduction of abuses both in its formation and operations. Properly utilized, the device is sound and economically and socially justified. But it has not been always so used. Many of the abuses we shall consider are only of historical interest at this time because legislative action and governmental regulation have effectively eliminated or discouraged them. But a few of the more flagrant abuses, especially as they applied to the public utility holding companies, must be discussed to make clear how they brought about the passage of the Public Utility Holding Company Act of 1935.[12]

1. *Disenfranchisement.* In order to control extensive properties with little investment, holding companies tended to raise capital by means of bonds and preferred stocks regardless of the soundness of this procedure in any given case. The effect of this intentional practice was the inequitable distribution of voting power among security holders. The persons with the greatest investment and practically the sole interest in the soundness of the subsidiary were deprived of a voice in management.

2. *"Fair weather" capital structures.* The unsoundness of top-heavy, overcapitalized, debt-burdened holding companies and producing and operating companies made them unable to withstand any

[12] For a fuller discussion of these abuses see J. C. Bonbright and G. C. Means, *The Holding Company* (New York: McGraw-Hill Book Co., 1932).

regulate. A state commission's control is vitiated or weakened when the holding company is outside its jurisdiction and controls matters that affect costs, assets, and income of a subsidiary. This might occur even when the subsidiary is doing wholly intrastate business and is under the commission's jurisdiction.

7. *Excessive rates to consumers.* The financial practices and manipulations of holding companies have often prevented price or rate reductions to consumers. In the case of railroads and utilities, excessive charges for services by the holding company, enormous fixed charges, and inflated items, became capitalized and were figured as factors in the determination of rates since utilities are entitled to a fair return on their capital investments. Even where an efficient subsidiary might wish to make a voluntary rate reduction, it could be prevented from doing so by decision of the absentee controlling interests.

Of course, not every holding company was guilty of all or even part of these abuses. But the list of abuses helps to explain why railroad holding companies were placed under the control of the Interstate Commerce Commission and gas and electric holding companies were brought under the supervision of the Securities and Exchange Commission by the Public Utility Holding Company Act of 1935. The inadequacy of state regulation and the collapse of holding company systems during the depression of the thirties also contributed to the passage of this Act.

The Public Utility Holding Company Act of 1935. A summary of the leading features of the Act and its accomplishments follows: [13]

1. *Registration of holding companies.* Companies owning or controlling 10 per cent or more of voting securities of an electric or gas utility company, or exercising a controlling influence over the management or policies of such a company, are termed holding companies under the Public Utility Holding Company Act of 1935. The Act requires holding companies with properties in more than one state to register with the Securities and Exchange Commission, stating details of organization, financing, and control.

2. *Integration.* The most important part of the Act is that relating to the integration and simplification of holding company systems. Each registered holding company is required to file a voluntary plan of reorganization accomplishing the purposes set forth in the Act, or it must comply with a Commission order for such reorganization if it fails to act voluntarily. Each plan must provide for the elimination of useless intermediate holding companies, and must not provide for retention of more than three tiers of companies in the hierarchy that remains after reorganization. Operating companies that remain must

[13] Complete information on the Act and SEC action under it may be found in Prentice-Hall *Securities Regulation* service.

constitute a single system both geographically and with respect to functions. Non-utility properties may be retained only if they are reasonably necessary or appropriate for utility operations.

3. *Divestment of subsidiaries.* Holding companies may use various means to rid themselves of underlying companies to comply with the Act.[14] Divestment has been achieved by the sale of securities for cash, by exchanges for outstanding holding company securities, and by paying dividends in securities.

4. *Financial rehabilitation of systems.* Another important feature of the integration clauses of the Act has been the financial rehabilitation of systems with return of effective voting power in each company to investors. Plans must provide for sound recapitalizations of companies upon a broad equity basis, for the "squeezing out" of watered assets built up through improper write-ups and accounting, and for the fair and uncontrolled election of directors. The effect of all the plans is to return as much control over operations as possible to local managements able and willing to respond to community needs. Other efforts have been undertaken to bring the companies within state authority, to eliminate top-heavy senior securities that burden subsidiaries and impair their credit and ability to endure depression conditions, to provide adequate maintenance and sound consumer rates, and to enable companies to resume dividend payments to investors. In order to prevent loss of these benefits and the recreation of unsound and useless concentrations, the Act gives the Commission power over new acquisitions to holding company systems.

5. *Securities of holding company systems.* The Commission has the power to impose terms and conditions for the protection of investors, consumers and the general public on the issuance of securities by registered companies and their subsidiaries. It may refuse approval of an issue for any one of a number of reasons. It may require protective provisions to be included in indentures.

6. *Accounting, records, and reports.* Because the holding companies utilized improper accounting methods as a device to "milk" subsidiaries of assets and earnings for their own benefit, the Commission has introduced rigid standard accounting regulations to which each company must conform.[15] Registered companies are also required to file periodic reports.

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[14] The student is advised to see the changes made by the Electric Bond and Share Co. pursuant to the Act. This was the largest of the public utility holding companies registered, and initially had five major sub-holding companies and 121 domestic subsidiaries. Its history provides one of the most interesting of the complicated examples of the dissolution of a great utility empire.

[15] Operating companies may be subject to the accounting rules prescribed by a state commission. Where an operating company is not subject to such rules, the SEC has required the company to observe those prescribed by the Federal Power Commission. This cooperation between Federal and state regulatory commissions has resulted in better and more uniform accounting procedures.

7. *Intercompany transactions.* Since many abuses involved intercompany financial transactions, these are now strictly regulated or forbidden. "Upstream" loans and credits—that is, from subsidiaries to holding companies—are prohibited. Loans or credits from holding companies to subsidiaries are permitted, but only in accordance with Commission regulations. Other transactions subject to rules relate to dividends, purchase by companies of their own securities, disposition of assets, and solicitation of proxies.

8. *Sales, service, and construction contracts.* The Act provides for the creation of service companies within a system which can furnish efficient services, fairly and at cost, to the system's companies. Interlocking personnel between any company and the service company are forbidden, as is any form of compensation, directly or indirectly, to any person primarily charged with holding company duties. The idea behind this provision is to prevent holding companies from making the service company a source of revenue. The Commission has full jurisdiction over these contracts, with authority to determine reasonableness of charges and whether or not the services are necessary or appropriate.

9. *Restrictions on management.* Directors and officers of holding companies are regarded and treated in the same manner as "insiders" with respect to their holdings of securities of system companies.[16] Also, in order to weaken or sever banker controls over the system, a registered holding company and its subsidiaries may not have on its board any official of an investment house or banking firm.

The most important financial results of the Public Utility Holding Company Act have been the gradual strengthening of capital structures of both operating and holding companies and the divestment of properties by holding companies to reduce their systems to single integrated operating groups. Divestment has largely been completed.[17] The holding companies have used the funds from the disposal of their subsidiaries to pay off their own senior obligations and then to pay liquidating dividends to their own common stockholders.

Positive aspects of the holding company. After this discussion of the abuses of the holding company principle and the legislation enacted to control them in the public utility field, it might be well to bring the student back to the positive aspects of the holding company device.

A sound holding company consists of functionally related properties in horizontal or vertical combinations integrated into unified businesses with strong concentrations of administrative and operational

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[16] See Chapter 14 on "Securities Markets and Their Regulation," p. 274.

[17] Progress under the Act is indicated by the reduction in the number of companies subject to the Commission.

controls at the highest level. The economic co-ordination of formerly competing companies, and the absorption of small, relatively inefficient organizations into an effective unit, represents a good horizontal combination. If properly administered, such combinations serve the public interest and are economically useful. Vertical combinations of, for example, suppliers and processors of raw materials, transportation facilities, manufacturing, sales and advertising companies, when functionally interdependent and built into a strong alliance, serving the primary corporate ends, confer upon the component elements considerable benefits through unified management and coordinated operations.

Other uses of the holding company device have been brought out in the discussion of its advantages and purposes. Since these uses can be accomplished without abuse of the holding company principle, and since the legality of the device is well established, it can be concluded that the holding company as a form of intercorporate relations will continue to find justification for existence.

Research Question

From Moody's, the reports of the SEC, or any other source, choose any public utility holding company system that was broken up under Section 11 of the Public Utility Holding Company Act and determine:

(a) How many companies comprised the "system" prior to its simplification?
(b) In what states did they operate? Were the companies physically connected?
(c) What was the value of the publicly held securities before simplification?
(d) How was the system simplified under the Act?

Problem

Show by means of a diagram and assumed figures how a holding company with assets of $6,000,000 could control an investment of at least 16 times that amount.

CHAPTER 26

Recapitalization, Readjustment, and Failure

Definition of terms. The capital structure of a business is generally characterized as being fixed for long periods of time. This does not mean, however, that once set the capital structure need not—or cannot—be altered. The fluid character of the economic system, with the resulting changes in the fortunes of business, makes it imperative that we become familiar with some of the problems in this area. Adjustments in the capital structure must occasionally be made as a company contracts in the face of failure or expands because of success. The causes that give rise to these fluctuations may be within the concern or without—for example, changes in the demand for the product or unusually fierce competition. Regardless of the effort and ability of the founders of the company, or its present management, changes in the capital structure are necessary from time to time.

Changes in capital structure may be either voluntary or involuntary. A voluntary change is one instituted by action of the management; an involuntary change is one initiated by bank or trade creditors, bondholders, or stockholders, often against the wishes of management. The changes may be effected by a recapitalization, a readjustment, or a reorganization. Before proceeding with this discussion it would be well to define the terms we will employ, as they will also be used in the following chapter. One must, however, understand that there is little general agreement as to the meaning of most of these terms.

A *recapitalization* involves a rearrangement of the capital structure—bonds, preferred and common stock, and surplus, or all of the elements of the capital structure. This action may entail an increase or decrease in the debt structure, the capital stock outstanding, and

the surplus. When applied to the preferred or common stock it may result in an increase or decrease in the number of shares, an increment or reduction in the par value of the shares or vice versa, and, finally, in the case of no-par shares a change in stated value at which such shares are capitalized. Preferred stock arrears may be eliminated through recapitalization.

A *readjustment* involves fundamental changes in the capital structure in addition to those mentioned in the definition of recapitalization, such as modification of the debt structure, changes in the interest rates, and modification of the protective provisions in the outstanding debt and preferred stock structure.

Reorganization in the financial sense embraces an over-all revision of the entire capital structure through equity proceedings or under the bankruptcy law by statutory legal procedure. A reorganization differs from a recapitalization and readjustment in several respects: (1) reorganization is usually a more drastic arrangement than either of the others; (2) reorganization is accomplished under the jurisdiction of a court, whereas recapitalization and readjustment are voluntary; (3) reorganization is usually forced on management by creditors whose claims are threatened by default, whereas recapitalization and readjustment are normally instituted by management; and (4) in reorganization a new corporation is often formed to take over the assets of the old corporation, and the old management is supplanted by a new management, whereas in both recapitalization and readjustment the company remains in existence and the management continues in control.

We shall consider first recapitalization and readjustment, illustrating their use under conditions of prosperity or depression by business enterprise.[1] In the next chapter we shall discuss methods by which a complete reorganization is accomplished under the jurisdiction of a court after failure has been judicially determined.

Legal procedure to effect a stock change. A recapitalization, altering as it does either the number of shares or the value of the shares, more often than not requires an amendment to the certificate of incorporation. Today the tendency is to include provisions in the certificate for such eventualities. Usually, a certain percentage of the security holders may effect a change in the certificate within specified limits. Provisions for callable preferred stocks (see page 78) simplify certain changes in the capital structure.

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[1] Detailed treatment of recapitalization and readjustment in relation to conditions of prosperity and depression are found in *Fundamentals of Investment Banking*, sponsored by Investment Bankers Association of America (Englewood Cliffs, N. J.: Prentice-Hall, Inc., 1949), Chapter 14, "Corporate Failure, Recapitalization and Readjustment," by Dr. Louis P. Starkweather.

All states have provisions permitting amendments to the certificate of incorporation. They are not uniform, but contain essentially the same requirements. New York Stock Corporation Law, Section 35, for example, contains the following provisions:

> Section 35. *Amendments of certificate of incorporation; reduction of capital.*
>
> 1. Subject to the provisions of sections thirty-seven and thirty-eight of this chapter, a stock corporation may amend its certificate of incorporation in the manner provided in subdivision two hereof, or may reduce its capital, by filing a certificate as provided in section thirty-six. Any such certificate may relate to one or more of the amendments or proceedings authorized by this section. * * *
>
> 2. The certificate of incorporation of any stock corporation may be amended to effect one or more of the following changes:
>
> * * * * * * *
>
> (C) To change its capital stock, or its shares, or the par value thereof, or the number thereof included in any class or series of a class, or the provisions governing its capital, including a change for any or all of the following purposes:
>
> (1) to authorize new shares of any class, with or without par value, or to provide in any manner described in section eleven of this chapter for the issuance from time to time in series of shares, then or theretofore authorized, of any class which is preferred as to dividends or assets, or both;
>
> (2) to eliminate from the enumeration and description of shares which the corporation is authorized to issue, any class of shares, or any series of any class, or any shares of any class or series, whether issued or unissued;
>
> (3) to increase the par value of any previously authorized shares, whether issued or unissued, that have a par value;
>
> (4) to reduce the par value of any previously authorized shares, whether issued or unissued, that have a par value;
>
> (5) to change all or any of its previously authorized shares with or without par value, issued or unissued, into the same or a different number of shares of any class or classes or any series of any class or classes, either with or without par value, or into the same or a different number of both shares with par value and shares without par value, of any classes or series of any class or classes;
>
> (6) if the corporation has shares without par value, to change its statements respecting capital, provided that the statement as changed shall be the statement prescribed either by paragraph A or by paragraph B of subdivision four of section twelve of this chapter; or if the corporation proposes to have shares without par value, to adopt either of such statements;
>
> (7) if the corporation is authorized to issue only shares with par value, to increase or reduce the amount of its capital stock in con-

Objectives of recapitalization. Recapitalization, as indicated by the definition at page 502, generally involves no additional financing by the company, but may be undertaken as a prelude to new financing. It is a revision of the already existing capital structure. The number of shares authorized or issued may be increased or decreased, the stock may be changed from par value to no-par or stated value, or the capital and surplus accounts may be altered through a transfer of amounts from one account to another. Such changes may be brought about by management to accomplish the objectives listed below. The methods by which they are accomplished will be explained later.

1. To capitalize the growth of the corporation. As a corporation prospers the earnings per share increase. When they become large enough to support the issuance of further shares a recapitalization is undertaken, otherwise the growth leads to undercapitalization, as explained at pages 169 et seq.

2. To bring a high-priced stock down to what is believed to be a more desirable trading range. This is usually done to make the stock more attractive to a larger number of investors or to facilitate the sale of additional securities by the company. Many persons would prefer to purchase 100 shares at $20 per share than 10 shares at $200, although the investment is the same. There is a greater speculative interest in the lower-priced security; if the cheaper stock goes up $1, the investor stands to make $100 profit, whereas if the more expensive stock advances the same amount, he stands to gain only $10. The investor also avoids the expense of buying less than 100-share lots. Finally, a good many persons would rather own 100 shares than 10; it makes them feel wealthier.

Thus, American Gas & Electric Company reported that between the time it split its stock in April, 1956, and the end of that year, the number of stockholders in the company rose from 39,000 to 41,500, an increase of some 6.5 per cent. Similarly, Union Pacific in 1955 split its stock five-for-one, thus bringing it down from around $200 to the more desirable range of $40. Of course, there had to be an exception to prove the rule: The American Telephone and Telegraph Company has 1,500,000 stockholders—more than any other company in the world—despite the fact that its stock is by all standards high-priced. But AT&T's stable earnings and dividend record attracted a large number of small stockholders, and for many years the company withstood repeated demands for stock splits.

3. To facilitate distribution of private holdings in closely held corporations. At the present time, and certainly within the reasonably foreseeable future, high estate taxes will force the owners of many close corporations to distribute or sell at least a part of their holdings to obtain cash. A stock split usually precedes this sale both

to increase the number of shares and to reduce the price per share. This is designed, of course, to render the stock more marketable.

4. To facilitate consolidations or mergers. In the case of a proposed merger or consolidation, it may be necessary to recapitalize the several corporations. This is accomplished as a step toward equalizing the values of the shares of the corporations to arrive at a simple and equitable basis for exchanging the stock. Any of the corporations that are parties to the combination may find it advisable to declare a stock dividend or to split up its shares before the exchange of stock takes place. Similarly, any of the combining companies may find it expedient to reclassify their stock. For example, a preferred stock may be created, or if it is already authorized, it may be increased and given to the common stockholders prior to merger. Where existing preferred stock is affected by a proposed reclassification of shares, the corporation must ascertain whether the change is permitted by the charter. The need for caution will become clearer when we discuss readjustments involving preferred stock.

In preparation for the exchange of the shares of the surviving corporation for the shares of the companies that are to be acquired, it may be necessary for the surviving corporation to make substantial changes in its capital structure.

5. To provide for the issuance of convertible securities. Where a company is about to issue convertible securities, either bonds or preferred stock, it must have a sufficient number of common shares authorized and unissued to cover all conversions. For example, a corporation offering for sale a $1,000 bond convertible into forty common shares must have forty common shares authorized but unissued at all times for each bond outstanding. American Telephone and Telegraph announced in 1950 a plan to sell convertible debentures and at the same time to increase the authorized common stock to cover the conversion requirements of the bond issue.

6. To absorb balance sheet deficits. This objective is typical of depression or post-depression periods. It involves a write-down of the capital stock and a corresponding increase in capital surplus followed by a write-down of assets and elimination of the balance sheet deficit against the capital surplus created. The assets written down may include goodwill, patents, accounts receivable, and inventories in varied amounts. Occasionally, a capital write-down may be made to create surplus reserves to absorb anticipated future losses. The general purpose of the foregoing operations is to improve the over-all financial condition of the company involved, particularly the reduction of overvaluation and, indirectly, overcapitalization.

In addition to absorbing write-downs, this change may also serve such purposes as facilitating the exchange basis for mergers or con-

solidations, the raising of additional capital, and the saving of taxes.

7. To simplify the capital structure. The capitalization of a corporation is, for the most part, a compromise between pressing needs and planned effort. As the corporation progresses through the various stages of growth in the ever-changing milieu of the economy, the need for funds is a constantly recurring problem. Securities may mature in unfavorable market periods, or burdensome provisions may have been necessary to make them sufficiently palatable to investors. The result may be, in many instances, a "gerrymandered" capital structure of several disconnected varieties of securities. To correct this, corporations may find it appropriate to simplify their capital structures. To accomplish the task, a new preferred stock might be issued to replace two—or more—classes of outstanding preferred, or additional common stock might be sold to retire one of several bond issues.

8. To comply with legal requirements. In many cases a change in capitalization is the outgrowth of failure and resulting court orders, but solvent corporations may be forced to amend their capital structure to conform to certain regulatory acts. The Public Utility Holding Company Act of 1935 provides for the mandatory dissolution of many companies holding stock in others, and the rearrangement of existing utility systems. This provision necessitated the revamping of several corporations' capital structures. The Hepburn Act had a similar effect in forcing railroads to divest themselves of stock in corporations producing commodities carried by them. The power of certain regulatory bodies, such as the SEC and the ICC, to disapprove new security issues of these companies indicates the continuing effect they will have on the capital structures of many of these concerns.

Methods of accomplishing recapitalizations. To accomplish the objectives of recapitalization the corporation may adopt various devices. Discussion of the most commonly used methods follows.

1. Stock dividends. A stock dividend has the effect of capitalizing surplus. That is, the surplus account on the balance sheet is reduced and the capital account is increased by the same amount. From that time on, since the surplus has become capital, it is not available for dividends. The student may well ask, "What does the stockholder really get since he owns the capital and surplus anyway?" Actually he gets nothing but an opportunity later to sell his share of the surplus as represented by capital stock received as a stock dividend. Of course, by a subsequent sale of his new shares he will lose a proportion of his control as well as dividend income.

To some extent this has occurred as a consequence of the Federal Income Tax policy. Dividends paid in cash are taxable immediately

as income, while stock dividends generally are not. (See page 406 for taxation of stock dividends.)

2. Stock splits. A stock split increases the number of shares, and a reverse split decreases the number. That is, a split can take the form of "two shares for one," or the form of "one share for two." Unlike a stock dividend, however, the surplus account is not altered. The split-up does effect a reduction, nevertheless, in the par value or stated value of the shares outstanding. Let us see how the stock dividend and the splits affect the balance sheet.

Before Stock Dividend

Capital: 100,000 shares common $10 par	$1,000,000
Surplus (earned)	$2,000,000
Earnings per share	$5.00
Dividend per share	$2.50
Market price (stock yields 5 per cent to owner)	$50.00

After the corporation declares a 100 per cent stock dividend we might expect the following changes:

After 100 Per Cent Stock Dividend

Capital: 200,000 shares common $10 par	$2,000,000
Surplus	$1,000,000
Earnings per share	$2.50
Dividends per share	$1.25
Indicated market price (stock still yields 5 per cent to owner)	$25.00

A stock split has a different effect as we shall see. If we assume the facts given above before the stock dividend, a five-for-one split would alter all of the items except surplus, thus:

After Five-for-One Stock Split

Capital: 500,000 shares at $2 par	$1,000,000
Surplus	$2,000,000
Earnings per share	$1.00
Dividend per share	$.50
Indicated market price (stock still yields 5 per cent to owner)	$10.00

A reverse split, one-for-five, would increase the earnings and dividends per share and the market price, in the above illustration.

3. Changes in the stated capital value of the shares. These would include changes in par value, from par value to no-par value, par value to stated value, or any other combination. For example, General Motors, in 1950 and again in 1955, lowered the par value of its stock by successive splits. Again referring to our illustration, we might find the following changes:

After Change to No-par Stock

Capital: 100,000 shares with no par value	$ 200,000
Surplus	$2,800,000
Earnings per share	$5.00
Dividends per share	$2.50
Indicated market price (stock still yields 5 per cent to owner)	$50.00

The only change has been a transfer from the capital account to the surplus account.

4. Purchase of treasury shares. A corporation may purchase its own shares in the market and retire them. Caution must be exercised, however, that this does not operate as a fraud on the creditors. Many states provide, as we have seen in Chapter 5, that a corporation may repurchase its shares only out of earned surplus.

5. Inducing stockholders to convert bonds or convertible preferred stock. Suppose a stockholder held a 5 per cent preferred stock with $100 par value convertible into 4 shares of common. If the common stock paid $1.25 a share there would be no inducement to convert; the preferred stock is senior to the common and the yield would be the same as on the common. However, if the common stock dividend were increased to $2 per share, the yield on the preferred would remain at 5 per cent while the yield on the common would be 8 per cent. Let us assume further that the company prospers and the dividend on the common is raised to $3.50 and the price goes to 35. The common stock now yields 10 per cent. However, it is unreasonable to believe that the common stock yield will remain at 10 per cent and consequently the common stock will sell at a substantially higher price—approximately $70. The preferred stock would be quoted at 140, but the dividend would remain at $5. The yield, at market price, will have declined to 3.56 per cent. Obviously, the stockholder would be tempted to convert. He would retain his paper profit of $40 and at the same time would increase his yield from 3.56 per cent to 5 per cent. The same principle applies to convertible bonds.

Recapitalizations occur in both prosperity and depression periods. In prosperity, they normally take the form of stock splits and stock dividends. In depression, they often take the form of reverse splits, that is, readjustments (write-downs and write-offs) involving decapitalization.

Objectives of preferred stock recapitalizations and readjustments. Management usually has one or more of four objectives in undertaking a recapitalization of preferred stock:

1. To eliminate arrearages of preferred dividends.
2. To reduce the dividend rate.

3. To eliminate burdensome provisions placed in the preferred stock contract for the protection of the stockholders.
4. To eliminate the outstanding preferred stock.

Before discussing these objectives and the methods by which they are accomplished, we must review certain aspects of preferred stock and the legal limitations on readjustments.

Limitations on preferred stock changes. Preferred stockholders are not only limited, but preferential, owners of the business in contrast to the common stockholders. The preferred holders may have certain rights in addition to the rights possessed by the common stockholder, such as the right to cumulative dividends, participation in residual profits, and protective provisions such as sinking funds. It is one thing to change the number of preferred shares, or to change the par value. It is quite another matter, however, to alter the dividend rate, to eliminate the unpaid and accumulated dividends, or to lessen the protective charter provisions.

The various states differ in their laws affecting such changes. Some states will not permit a readjustment that eliminates dividend arrears. Others, like New York, permit alterations in the preferred contract and the elimination of any dividend arrears if agreed to by a two-thirds vote. The New York Stock Corporation Law provides, however, that any holder of stock affected by such an adjustment has the right to demand payment of the fair value of his stock within a specified period. If a fair value for the stock cannot be agreed upon by the corporation and the stockholder, the statute provides that an appraisal be made and a fair price fixed.

A preferred stockholder who wishes to defeat the proposed recapitalization has two remedies in addition to his right to appraisal. If he has reason to believe that he can command sufficient votes to defeat the plan (one vote more than one-third is all that is necessary), of course, that is the simplest procedure. Where he has reason to suspect fraud or that he is being treated unfairly, he may have recourse to the courts for an injunction restraining the execution of the plan.

Recapitalization to eliminate arrearages of preferred dividends. Although accumulated dividends are not a fixed charge like bond interest, nevertheless their existence weakens the credit of the corporation as it indicates a poor earnings record or that the working capital position of the company is probably weak. Further stock financing will be out of the question, while borrowing will be almost impossible, except at prohibitive rates of interest. If the accumulations are not too great and the company enters a period of prosperity, the arrearages may be liquidated by payments in cash. Usually, however, some active steps must be taken to induce the stockholders in-

volved to cooperate with the management in various plans of recapitalization.

The simplest plan would be to eliminate the arrears by giving the preferred stockholders full payment in common shares. A more costly offer, however, such as a prior preferred stock or bonds in the amount of the accumulated dividends may have to be made. Rarely, if ever, have bonds been issued for the payment of such arrearages. Such a solution can readily be seen as a difficult one, though not impossible. The need for acquiring the preferred stockholders' consent may require this method of payment. The stockholder must choose the smaller fixed return or the larger contingent return. The corporation may experience a tax saving with the issue of bonds, as the interest will be deducted before the corporate income tax is computed.

Recapitalization to reduce the dividend rate. Earlier in this book (page 78) we explained that preferred stocks are made redeemable to give the corporation an opportunity to call in the stock if changes in the prosperity of the enterprise or in interest rates make the dividend rate on the preferred unnecessarily high. We also mentioned in other places that sometimes the preferred is called and paid off with the proceeds of a new preferred issue bearing a lower dividend rate. If the preferred is non-callable, the corporation must resort to reclassification by amendment of its charter to accomplish the same purpose. To encourage the preferred stockholders to agree to a plan that would result in their receiving a lower dividend on their holding of stock, would seem to require strong persuasion. The corporation might, for example, make the new preferred stock convertible, thus offering the holders the possibility of a profitable conversion should the common stock rise in value because of the company's prosperity. Some corporations, however, successfully adjusted their 5 per cent and 7 per cent preferred to a 4½ per cent dividend, without such inducements.

When the adjustment is sought to strengthen the financial position of the corporation and enhance its credit standing, the preferred stockholders might agree to the plan even though they suffer a monetary loss. As stockholders they have a share in the company's over-all prosperity and would rather accept the lower potential common dividend rate than see the company subjected to the dangers inherent in an overcapitalized or complex capital structure.

Readjustment to eliminate burdensome provisions. Certain provisions in the charter describing the rights of preferred stockholders may restrict and limit the fiscal activities of the company and create obstacles to future financing and management planning. For example, the charter may include restrictions on the amount of debt that the

corporation may incur, may place a ceiling on the amount of preferred stock that can be issued, may limit the amount of earnings available for common dividends, or may require a certain ratio to be maintained between preferred stock and working capital. We have already mentioned an instance where preferred stock was redeemed to eliminate burdensome provisions.[3] If the preferred is not redeemable, or if it is and redemption is not desirable, it may be necessary to amend the charter to remove the objectionable provisions.

Readjustment to eliminate preferred stock. The complete elimination of a senior security with contingent charges may be found necessary. The maintenance of even the ordinary preferred dividends may be so uncertain as to make it desirable to exchange the outstanding preferred stock and arrearages—if any—for common stock. The company may be better able to survive future periods of contracting income without the usual difficulties. Also, if several different preferred stock issues are outstanding, the elimination of one or more may aid in simplifying the capital structure. The practical problems of accomplishing such a task are, of necessity, difficult. If the preferred stock is callable, the difficulty is not quite so great. On the other hand, if it is not, then an inducement, such as a partial payment of cash, must be offered the preferred stockholders to convince them of the wisdom of relinquishing their position. Opposition to recapitalization plans, however, has not been great or very effective. The rather large expenses involved plus the general apathy of stockholders makes such opposition unlikely.

Objectives of debt readjustment. Ordinarily, the term "debt readjustment" is used to describe the process whereby one form of debt is replaced by another type of debt. If no new money is acquired by the corporation, then it is, strictly speaking, a refinancing. Companies have various objectives in seeking to readjust their debt. In numerous cases, though, the need to change the debt structure emanates from financial difficulties bordering on failure. The following are, among others, the objectives of such readjustments:

1. To lower the interest rate. A company may be motivated to accomplish this because (a) long-term interest rates as evidenced by money market trends make refunding highly desirable even though the outstanding bonds are non-callable, (b) the company finds it necessary to reduce fixed charges and cut operational costs and expenses in order to meet the interest requirements of the readjusted debt.

2. To extend the maturity date. A company may be facing the prospect of a large bond issue coming due very soon. If the com-

[3] See note 11, Chapter 5.

pany needs time and the management seems sound, the present bondholders may well extend the maturity date of the issue. If the bondholders pursued their legal rights, the company might be forced into bankruptcy or receivership with the harmful effects felt by both debtor and creditor. To get bondholder consent to such an extension, the issuing company may be forced to add features that will induce the creditors to grant the extension.

3. To reduce the principal. An unusual adjustment of this sort may be found necessary, but such a request amounts to a composition agreement of sorts. It is a drastic change and may not be possible without some form of court intervention or recourse to a form of voluntary reorganization.

4. To fund short-term debt. A company may wish to accomplish this for two reasons: (a) it may find itself embarrassed to meet maturing short-term obligations, (b) it may wish to take advantage of low interest rates on funded debt or term loans or incur a five- or ten-year amortizing loan rather than incur higher interest charges through a series of short-term bank loans.

5. To secure a release from burdensome provisions in the bond indenture. The requirements for a sinking fund or restrictions against further debt financing may make it impossible or impractical to obtain further financing. The company may want certain assets securing a bond issue released from an encumbrance to make them available for additional borrowing. The bondholders may be asked to subordinate their lien to facilitate a new issue.

Debt readjustment presents the corporation with a different problem from that of stock reclassifications and readjustments, which we have just discussed. Stockholders, whether common or preferred, are the owners of the business and, subject to the requirement of fair dealing among themselves, may do pretty much as they wish with their property. Creditors are in a vastly different position. Short of bankruptcy or reorganization, there is no law to coerce creditors into following a plan of readjustment. There is no provision for binding all creditors where two-thirds are willing to be bound, as in the case of preferred stock readjustment. Any readjustment will have to be accomplished by a group of creditors who have been persuaded that it is to their best advantage to follow a proposed plan of debt readjustment. Any conduct that avoids legal proceedings, which are expensive and slow and which usually result in creditors finally receiving a very small percentage of their claim, is usually appealing. Some mutually acceptable voluntary method of readjustment is often more profitable than legal proceedings where the facts disclose that (1) the financial failure is not severe and can be attributed largely

to a temporary economic condition, or (2) a business recession rather than the neglect or indifference of management is the cause of difficulty, or (3) the financial embarrassment emanates from the maturity of one or more large accounts rather than from a chronic shortage of working capital, or (4) the management has proven itself to be generally astute.

Methods of debt readjustment. The methods employed to readjust debt will vary with the seriousness of the causes of financial difficulty and the objectives to be accomplished.

1. Changes through supplemental indenture. Such an agreement, made with the proper consent of the bondholders, might permit an extension of maturity, lowering of the interest rates, or reductions of the principal. If there is a large debt maturing and cash is not available, an extension of the maturity for several years might offer an easy and somewhat painless solution. A reduction of the rate of interest might possibly be received favorably where the bond is noncallable, the interest rate is high, and sufficient inducement is added. If the loss in interest is offset by the addition of compensating features such as the addition of a sinking fund, or a provision making the issue convertible, the consent of the bondholders is more easily procured. When current interest rates are at a low level, however, a creditor might doubt whether a business unable to meet a 3 or 3½ per cent interest rate is worth the risk. A proposal to reduce the principal has a limited chance of success because a recalcitrant creditor can readily force the company into a reorganization under Chapter X of the Bankruptcy Act.
2. Refunding. This has been explained in Chapter 9.
3. Substitution of one kind of security for another, for example, bonds for short-term notes, installment notes for open accounts, stocks for bonds, or other means of compensation for arrears in interest.

Three methods of reconstruction without court intervention. Three remedies for dealing with an unsuccessful business are available that are intermediate between management-controlled readjustment, already discussed, and bankruptcy reorganization under jurisdiction of the courts, to be discussed in the next chapter. These three remedies are (1) out-of-court agreements in the form of common law composition settlements, (2) assignment for the benefit of creditors, and (3) creditor committee management. Creditors of small business concerns usually consider the advantages to be derived from these methods and frequently accept them. They are usually not appropriate where there are numerous creditors because of the practical difficulty of securing co-operation of the creditors and because a dissatisfied creditor could probably throw the debtor into bankruptcy.

Common law composition agreement. This out-of-court form of settlement agreement is an instrument by which a compromise can be arrived at quickly, economically, and with the least disturbance to the debtor's business. Under this type of settlement the debtor may offer a composition (part payment) in full settlement of the account. Under this arrangement the creditors must agree among themselves and with the debtor to accept a lesser amount in full payment of their claims. As an alternative to this, the debtor may request an extension of time to pay the account. The creditors may be aware of the advantages to be derived from extending the time of payment. To force payment by legal action may net the creditors less in the long run than if they had granted additional time to pay. An extension is a useful device when the number of creditors is not large or the busi ness is relatively small. But the above methods of out-of-court adjustment do not always prove effective because such settlements require the approval of all the creditors. Legally, two or more creditors may effect a composition agreement; practically, however, it is desirable that all of them join the agreement. Those not joining may force the debtor into bankruptcy, and little will be accomplished by a composition agreement of only part of the creditors.[4] Sometimes ignorant or obstinate creditors refuse to co-operate with the majority, even though the acceptance of the settlement agreement is in the interests of all creditors. Failure to obtain the necessary consents may lead to the use of one of the other methods of administration.

Assignment for the benefit of creditors. If *A*, for example, is beset by clamoring creditors and fears that some will get advantages over others simply because they are more aggressive, he may assign all his property to some person "for the benefit of creditors"—that is, for the benefit of all creditors. Under such circumstances a vindictive creditor gets no advantage, because there is no property in the hands of a debtor on which a judgment might rest as a lien. The assignee administers and sells the property and distributes the proceeds to the creditors in accordance with their respective rights. The advantages over bankruptcy lie in the quick action that normally accrues where the ponderous machinery of bankruptcy is avoided and in the better opportunity for marketing the debtor's assets at a higher price where orderly liquidation takes place.

The remedy just described is disappearing from use because under

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[4] The Bankruptcy Act, Chapter XI, provides for compositions called "arrangements," accomplished through court supervision. These are not to be confused with the common law composition discussed above. Such agreements are binding on all creditors when and if they are approved by a majority of each class of stock and the court.

the Bankruptcy Act an assignment for the benefit of creditors is a so-called "act of bankruptcy" upon which a petition in bankruptcy may be predicated. Since, then, an assignment will almost inevitably lead to a bankruptcy decree, it is usually considered better to get into the bankruptcy courts in some more direct way.

Development of creditor committee management. During the industrial crisis of 1920–1922, many corporations faced insolvency because of the decline in trade and the drop in commodity prices. Banks that had loaned money on inventories at inflated values found that in order to protect their interests they had either to force the delinquent corporations into bankruptcy or find some less costly and more speedy and efficient method of liquidating the debtor's estate. They devised a system of creditor committee management to solve the problem. Under the system, an agreement is entered into between the debtor corporation and the creditors, whereby control of the embarrassed business is turned over to committees chosen by the latter. The agreement generally provides also for the subordination and extension of claims by creditors, and for advances of new funds by banks to provide the company with working capital.

Generally the internal organization of the company is not disturbed; only such changes are made as promote efficiency and effect economies in operation. After a short period of operation under policies formulated by the creditors' committee, those in charge of managing the company determine whether recovery under the new regime is possible, or whether reorganization or liquidation is necessary. If reorganization is undertaken, the creditors' committee supervises the reorganization procedure and acquires representation on the board of directors of the new company.

Creditor committee management with the aid of adjustment bureaus. Creditor committee management, as an alternative for proceedings in bankruptcy, has received the support of the National Association of Credit Men. The "friendly adjustment" system, which is the name frequently applied to creditor committee management, has developed successfully to the point where settlement of embarrassed enterprises can be handled by a creditors' committee working through its own liquidating agent, an adjustment bureau on the approved list of the National Association of Credit Men. Throughout the country, the member associations of the National Association of Credit Men have created and fostered approved adjustment bureaus. These bureaus are specialists in the field of liquidating insolvent estates and rehabilitating embarrassed debtors. The cases handled are roughly classified as "extension cases" and "assignment cases." In an extension case, the business of the debtor is kept going through the co-

operation of debtor and creditors; in an assignment case, the business is liquidated under an assignment, or deed of trust, taken by a bureau manager as trustee for the creditors.

Advantages and disadvantages of friendly adjustments. Liquidation through a friendly adjustment is much simpler than through bankruptcy proceedings. The simplicity results in speedier settlements, reduced costs of administration, higher realizations in reducing assets to cash, and curtailment of fraud. These advantages do not justify a conclusion that the friendly adjustment method should be substituted in every case for bankruptcy proceedings. Bankruptcy affords a method of legal supervision and furnishes certain protection against fraud that is necessary in the settlement of many insolvent estates. The receiver appointed by a court is in a position to set aside questionable claims of creditors as well as burdensome and unprofitable contracts. The creditors' committee does not have that power. Nor does it have the power to stop legal actions brought against the business by creditors who do not enter into the arrangement. The appointment of a receiver immediately halts any action against the company by creditors. On the other hand, the creditors' committee has much more freedom than a receiver and can respond quickly in situations that require immediate action.

The assignment executed by the debtor is an act of bankruptcy, which gives any three creditors, with unsecured claims aggregating $500 or more, the right to file against the debtor a petition for involuntary bankruptcy. The possibility of such action is, of course, a weakness of the friendly adjustment method. Another serious objection to the friendly adjustment is that those who take over the management of a defunct business subject themselves to damaging criticism in the event of an unsuccessful administration.

Importance of the failure problem. The serious economic consequences arising from business failures in the United States can be readily gathered from statistics furnished by Dun & Bradstreet. It can be seen from the table on page 519 that although the ten post-war years saw less than half as many failures as the ten depression-spawned pre-war years, liabilities involved still amounted to a whopping $3.4 billion. (The years during which the effects of the war economy were felt have been segregated.) The rate of failure per 10,000 concerns reached a high of 154 in 1932, it dropped to a mere four in 1945 but then began to rise slowly again. In 1950 and 1951 it stood at 34, by 1956 at 48, and for the first half of 1957 at 54. It is of extreme importance, therefore, that we understand the broad underlying causes of failure and the related problems. Our interest is not in the failures themselves, but rather in the causes and events leading to financial embarrassment. We may acquire from such investigation important

information that may forestall or prevent such an occurrence. Our interest goes much further than this, as we prepare to discuss various methods of reorganizing firms that have become insolvent.

Years	*Number of Failures* [5]	*Total Failure Liabilities* [6]	*Failure Rate per 10,000 Listed Concerns* [7]
1930–1939 (10 years)	177,357	$4,250,415,000	85.7
1940–1946 (7 years)	41,253	$ 578,124,000	19.5
1947–1956 (10 years)	86,404	$3,407,343,000	32.7

The term "failure," when applied to a business enterprise, may suggest to the layman anything from inability to earn a profit, to a complete liquidation of the assets followed by a final discharge in bankruptcy. In ordinary business parlance, terms indicative of financial disturbances in a business are used indiscriminately and may or may not convey the legal or even accepted meaning of the word.

The same confusion will arise in the mind of the reader unless at the outset he has a clear understanding of the nomenclature of the subject. (The careful student should distinguish between diseases, causes, and remedies.) We shall first outline the nomenclature, giving definitions where necessary, and then shall proceed in this chapter to a more extended discussion of financial diseases and their causes. The remedies for failure run the gamut from simply "turning over a new leaf" to a complete reorganization. Recapitalization, readjustment, assignments, and credit committee management are other possible solutions, as we have already seen.

[5] "Business failures include those businesses that ceased operations following assignment or bankruptcy; ceased with loss to creditors after such actions as execution, foreclosure, or attachment; voluntarily withdrew leaving unpaid obligations; were involved in court actions such as receivership, reorganization, or arrangement; or voluntarily compromised with creditors." (From explanation to above statistics in Dun & Bradstreet booklet "The Failure Record Through June 1957," p. 14.)

[6] "Liabilities, as used in this [table], refers to *current* liabilities, and has a special meaning; they include all accounts and notes payable and all obligations, whether in secured form or not, known to be held by banks, officers, affiliated companies, supplying companies, or the Government. They do not include long-term, publicly-held obligations. Offsetting assets are not taken into account." (From Dun & Bradstreet, *op. cit.*, note 5.)

[7] "Listed concerns represent the business enterprises listed in the Dun & Bradstreet Reference Book. This Book includes manufacturers, wholesalers, retailers, building contractors, and certain types of commercial service including public utilities, water carriers, motor carriers, and airlines. This count by no means covers all the business enterprises of the country. Specific types of business not listed are: financial enterprises including banks, and mortgage, loan, and investment companies; insurance and real estate companies; railroads; terminals; amusements; and many small one-man services. Neither the professions nor farmers are included." (From Dun & Bradstreet, *op. cit.*, note 5.) Each rate given in the table above is an average of the annual rates for the years included in the period covered.

Financial diseases. A company may be said to be prosperous when it is able to meet all its obligations as they mature, and to pay a reasonable return on the investment, with something over to provide for growth and for the shortcomings of poor years. If a concern does not meet these requirements, it may be said to be a failure.

There are several stages of business failure, ranging in seriousness from economic failure to confirmed insolvency. *Insolvency* has two meanings. Independent of statute, it may be said that a business concern is insolvent when it is unable to pay debts as they become due in the normal course of business. The Bankruptcy Act provides that a business is insolvent whenever the aggregate of its property, at a fair valuation, shall not be sufficient to pay its debts. Strict usage confines insolvency in the bankruptcy sense to a business that has been adjudicated insolvent by the court.

Economic failure may be said to exist in those cases where the business enterprise does not satisfy an economic demand, or does not earn a return adequate to compensate for the risks involved. Such a condition does not require a suspension of business nor does it imply losses to the creditors. Outwardly the concern may appear to be active and solvent. It is characteristic of this stage that the business gradually drifts into a stage of financial embarrassment and then financial insolvency until the condition is recognized, and either corrective action is adopted or legal procedure confirms the insolvency. *Financial failure* involves actual losses to creditors with or without suspension of business activity. At first the company is hard put to meet its obligations as they mature. Later there is an excess of maturing obligations without the means with which to meet them, and finally the total liabilities exceed the total assets. *Legal failure* is a confirmed insolvency, that is, the financial failure has been adjudicated by the court and a receiver or trustee has dissolved the enterprise and distributed the assets, or has reorganized the enterprise under the Bankruptcy Act.

Underlying causes of failure. The inability to pay debts as they mature is the immediate cause of virtually all failures. The lack of cash or the like, therefore, is essentially the cause of most financial collapse. Such a situation, however, is merely the result of more basic factors. In many cases failure may be the result of several causes converging upon a firm in such a fashion as to bring about its demise. The causes of failure may be divided generally into two classes, those operating from the outside, and those operating from within.[8] Some have questioned this analysis and maintain that there is only one cause of failure—managerial incompetence—and that all others are

[8] A broad and detailed treatment of the problem of underlying causes of failure is available in Louis P. Starkweather, Erich A. Otto, and H. Randall Kreger, *Policies and Practice in Corporate Finance* (New York: New York University Press, 1951).

but manifestations of that cause. The discovery of the causes of failure is important; their classification into variously named categories is secondary.

The external causes of failure are those that may possibly be obviated but cannot be eradicated. They include competition, changes in demand for the product, acts of God, the business cycle, governmental action, and unfriendly acts of labor or other organizations. The internal causes may be summed up in two words, "incompetency" and "fraud." We shall consider the internal causes in much greater detail after considering generally the external ones.

Competition. Competition up to a certain point is stimulating; beyond that it is exhausting. Management must anticipate competition commencing with the promotion stage of the enterprise. What provision shrewd management should make to meet all competition is not easy to determine. Certainly it will affect their conclusions about such matters as cash position, working capital requirements, reserves, prices, dividends, and plans for expansion. Ruinous competition that requires even the most efficient to sell at cost, or below cost, for long periods of time is beyond the control of even the most farsighted management. Such conditions were experienced throughout the United States during the 1930's and led to price-fixing on an industry-wide basis under the NRA. Temporary conditions of ruinous competition may be found from time to time in every locality. Almost everyone can recall gasoline price "wars" in his neighborhood, which drove the price down (to the delight of the motorist) even below the cost to the operator of the station. If conditions are such that profits are humanly impossible because of competition, only two options are open to the businessman: (1) combine with some of the competitors, or (2) liquidate and withdraw from the field.

Change in demand for the product of the company. Changes in the demand for the company's product very often lead to failure. Substitutes are constantly threatening almost every product. In recent years the electric razor has offered competition to the safety razor as the safety razor had competed with the straight razor. Anti-histamine tablets promise to relieve the common cold more easily than the old cold pills to which we had grown accustomed. Television is a strong threat to the motion picture industry. As in the case of competition, it is questionable whether this type of situation can be labeled entirely an "external" cause of failure. Should not management take steps to protect itself and its business against what is more than likely to transpire in any industry? The accumulation of large reserves, particularly in the form of cash, would enable the company to weather the effects of a shrinking demand for its product. The present activity of many companies in the field of research is an appropriate example

of an attempt to solve this problem. These concerns are in a much better position to meet the changing whims of the consumer by taking the lead in developing and introducing new and improved products. An excellent example is the constant research activity of the Radio Corporation of America which has helped maintain the corporation's position of leadership in the industry. The stronger businesses in the brewery field met the challenge in a different manner. When the Eighteenth Amendment became law they adapted their plant and equipment to manufacture chemicals and unprohibited beverages. They survived the period and returned to their original product upon repeal of the amendment.

Acts of God. Failure may also result from circumstances entirely fortuitous in nature. Lawyers call them "acts of God." Fire, windstorm, explosion, and flood are examples. Management obviously cannot prevent the catastrophe, though here again they can prevent some loss to the business by adequate insurance. Unfortunately, insurance against the loss occasioned by the act of God and also the loss of profits while the building or plant is being rebuilt, is expensive. The businessman also knows that insurance cannot protect him against the loss of his customers who must go elsewhere while he is rebuilding his plant and who somehow never come back to him. Nor can insurance prevent competitors from taking advantage of the situation.

Governmental acts. To acts of God we must add "acts of the Sovereign," or, more realistically, Federal and state laws. The Eighteenth Amendment and state laws against fireworks are examples. Sometimes a court decision may reduce what was previously a successful business to a point where failure is inevitable. The basing-point decisions of the Supreme Court furnish an example. The beet-sugar growers of the Rocky Mountain area were able to sell their product on the Pacific coast where it came into competition with the sugar cane of Hawaii, and on the Atlantic coast where it came into competition with the sugar cane from Cuba, by absorbing the freight costs. If this is outlawed by the basing-point decision, the sugar growers of this region can compete neither on the Pacific nor the Atlantic coast. They are not able to reduce the price by the amount of the freight cost to each town, as that would result in different prices to neighboring towns in competition with each other—a violation of the Robinson-Patman Act. As a result, they must sell only to the local market, which is far too small to produce the gross revenue they need.

In periods of emergency or war the imposition of wage and price controls has had adverse effects on many firms. Aside from such unusual periods, tariff revisions have resulted in serious effects upon individual businesses—even entire industries. The legislation of the early thirties aimed primarily at combating the depression caused

costs in some businesses to rise. The management of several firms, unable to cope with such increases, failed.

The student of finance should be aware, however, that much legislation has been beneficial to many firms, while at the same time injurious to only a few. The relationship that prevails between government and business is a complex and changing fabric. An informed and sophisticated management must stay abreast of the trends in public policy and be ready to make necessary adjustments as the need arises.

Adverse acts of labor or other organizations. In recent years labor organizations have come into positions of power. As labor demands increase, costs rise to a point where to compete and earn a satisfactory return may become almost impossible. The adverse effects are generally more pronounced in small firms or where the labor cost comprises a large portion of total cost. The effect may also be greater on marginal firms, especially under industry-wide bargaining agreements. The consequences are not always direct. In many cases the company supplied by such concerns is affected adversely, and this has further adverse results down through the productive process.

Other groups may be the source of hostile acts powerful enough to bring about failure. From time immemorial, religious organizations have condemned certain activities, such as card playing, consumption of alcoholic beverages, and gambling. Through the media of radio, television, and newspapers, crusades may arouse the public to a point where some firms, especially local concerns, are forced out of business.

Fortunately, group action either by labor organizations or others is not entirely unpredictable. Of further importance, however, is the ability of management to plan for such exigencies and take necessary steps to alleviate the results.

Business cycle. A recession may not be the direct cause of failure of a particular firm. Poor policies during periods of prosperity are merely brought to the surface when demand contracts fall. Recessions may then be considered a cause—though secondary or indirect—of failure.

Some businesses are more recession-resistant than others. Those which produce necessities are usually better able to withstand a contraction in the cycle than those producing luxuries. Businesses that carry large inventories, have long production processes, or rely on other businesses for their markets are more vulnerable to such fluctuations. One might argue that recessions are not the cause of failures, but only reflect the inability of firms to adjust to changes in demand. Such periods call for resourceful and aggressive action by management.

Internal causes of failure. Causes of failure in this class are generally attributed to incompetent management. To determine precisely whether management was truly responsible or that it was beyond the ability of man is not an easy task. The management of a concern cannot be expected to possess superhuman powers. This is not to say, however, that astute and capable management cannot be expected to make provisions for variations in demand, increased competition, or acts of God.

Causes of failure arising from within the business may be classified as follows:

I. Poor management in departments other than financial.
  A. Inadequate revenues, due to:
    1. Defective promotion (initial organization, expansion, or reorganization).
    2. Incompetent sales organization.
    3. Poor quality of product.
  B. High operating expenses, due to:
    1. Improper organization.
    2. Neglect of details of management.
    3. Unprofitable products.
    4. Archaic machinery and production methods.

II. Financial management.
  A. Overcapitalization, arising out of:
    1. Poor financial plan.
    2. Bad marketing of securities.
    3. Poorly timed sale of securities.
    4. Issuance of securities to obtain unprofitable subsidiaries.
  B. Excessive floating debt, arising from:
    1. Acquisition of fixed assets through use of short-term credit.
    2. Overexpansion of business without provision for new working capital.
    3. Incompetent credit and collection department.

Inadequate gross revenue. Some examples will be given to clarify the reasons mentioned in the outline for inadequate revenues.

Sometimes the revenues are inadequate because the marketing department is incompetent. And again, the disappearance of business may be attributed to the production of an inferior commodity or service that people will not buy when there is an option to buy a competing product, or without discomfort, to go without the product entirely. On the other hand, the market may be fertile enough, but the company may have inadequate means of reaching it or may be attempting to supply it with a product somewhat different from that

which the market demands. The trouble here may be laid at the door of the sales department.

To meet conditions of failure arising from all these causes requires the application of methods a description of which is not within the scope of this book.

High operating expenses. The trouble may be located in the producing departments, whence the difficulty may probably be still further traced to financial delinquencies. Insufficient maintenance of existing machinery, failure to mechanize and eliminate costly labor, uncoördinated production, lack of coördination with other departments, and the like, may cause a concern to be a high-cost producer. Business is always a shirtsleeve affair, and unless someone with responsibility and interest is in charge of the important posts and is always ready to watch the myriad of details that make up any enterprise, waste will eat up the profits.

Overcapitalization. We have just discussed causes that may operate continuously but that can readily be obviated by good management. The record of adversity arising from these causes is found in the income statement of a business; gross revenues are low or operating expenses are high. Overcapitalization, however, is carved right into the structure of the business. The dangers inherent in overcapitalization have been discussed in the chapter on capitalization. The disease may arise from a poor financial plan—or, as is more likely, from the absence of a plan. Companies continue to grow, interesting themselves principally in ordinary business problems and treating the financial problems as extraordinary occurrences to be settled by the application of the most convenient expedients. Anything that is done will be justified by future earnings. Moreover, since most financial operations are undertaken in the flush of unusual prosperity or in the depths of unusual adversity, the same care is not observed in making financial plans that would be used under normal circumstances. The promoter, for example, is a blind optimist, and the directors of a carelessly managed company are like drowning persons catching at straws. Overcapitalization also arises from unprofitable expansion, or from expansion improperly carried out. The issue of too large an amount of bonds, resulting in excessive fixed charges, may cause failure. The failure may occur in the initial financial plan or in subsequent periods of expansion. Bond financing affords cheaper rates and material tax savings,[9] which encourage its use. Such unwarranted use of this type of security may render a company vulnerable to small declines in earnings. A more conservative approach to the choice of securities would take this possibility into consideration.

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[9] Interest on bonds is a deductible tax item whereas a dividend is not deductible.

Excessive floating debt.[10] Perhaps most failures reveal lack of working capital as their direct cause. However, lack of working capital is hardly a cause—it is a symptom; the causes are more deeply seated. Current funds may dwindle away simply because a company is operating at a loss. These fundamental causes we have already discussed. There are, however, other causes that operate directly to exhaust working capital.

Companies frequently go on expanding out of profits, making commitments in the purchase of assets that ought to be furnished from fresh funds obtained through the sale of stocks or bonds.

As the fixed assets increase, the business itself expands and more funds are required for working capital. For example, goods are sold by salesmen on sixty days' credit. Every sale made by the salesman probably involves an outgo of funds, equal to one-fifth of the amount of the sales, two or three months before any cash is received from the sale, because salesmen's commissions are usually paid when the sale is made. Moreover, additional cash is required to make and ship the goods. Therefore, as business increases, the outflow of cash tends to keep ahead of the inflow. It happens, of course, that businesses do most of their increasing in the months following a period of general depression, during which the effort to keep the organization together usually involves a heavy drain on cash resources. Moreover, as a business expands, the demand for fixed assets increases, and the directors are likely to lose their good judgment in the exuberance of prosperity and to permit current funds to be turned into fixed assets. The causes that deplete a corporation's working capital are numerous and, frequently, difficult to detect.

When a period of prosperity overtakes a company, and new orders pile up, the credit department is likely to lose some of its caution. Collections will be permitted to drag because the volume of collections is large, absolutely though not relatively. When the period of prosperity reaches its crest and reaction sets in, the careless concern's own creditors will be more insistent for prompt payment, and its dilatory debtors will postpone payment.

A more insidious cause of failure, growing out of the use of current funds to build up fixed capital, is the lack of foresight of promoters and managers in providing funds for building up intangible assets.

High operating expenses, overcapitalization, excessive floating debt, and unwise dividend policies are usually the result of poor budgeting or no financial planning and can often be remedied by an efficient management.

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10 Floating debt simply means current liabilities, though it connotes that part of current liabilities which, if the company were in a sound condition, could be funded into long-term obligations.

Responsibility for detecting failure tendencies. A vigilant watch must be maintained at all times to detect failure tendencies and to correct them if possible. Remedial action to prevent defaults in the payment of an account due, interest on long-term debt, sinking fund payments, or a dividend on stock will often obviate financial embarrassment or bankruptcy. Management, short-term creditors, investment bankers, and security holders all have a stake in this "preventive maintenance" and a share of responsibility in giving effect to it.

Management is primarily responsible because it has the best opportunity to maintain a constant check on operations and to take immediate corrective action. The preparation and proper interpretation of adequate financial statements, internal reports, statistics, forecasts of business conditions, and budgets for guidance and control are means toward discharging this obligation. Often, however, the correction of failure trends is not within the power of present management. For example, failure tendencies caused by acts of God, new laws of both the Federal and state governments, long-term financial commitments of predecessors, and weaknesses in the original promotion may make failure inevitable.

Creditors have a responsibility toward themselves and the public, and to a lesser extent toward the debtor. An overextension of credit encourages business failure and widespread economic loss. Although creditors do not have all the primary sources of information possessed by management, nevertheless they have ample means at their disposal to exercise care. They can, and should, demand certified financial statements as a condition precedent to the extension of credit. Facts on which to judge the character of the management, the capacity to repay the loan, and economic conditions are not difficult to obtain and analyze. In the past, overextension of credit contributed to national panic and depression, but today the tight rein held by the Federal Reserve System on extension of credit plus other Government regulations make a national panic highly improbable.

The investment banker has an immediate responsibility when he offers the corporation's securities for sale. His reputation could easily be damaged in the eyes of his customers if he offered unsound securities. A cautious investment banker will examine the original promotion with care. He will appraise the earnings and potential earnings to prevent future default on security obligations. Finally, he will endeavor to maintain some degree of control by participation in management as a director.

Security holders, both bond and equity, can study financial statements and other periodic reports of management, and newspaper accounts of interviews with management, though the latter is usually

an inferior source of information. The stockholders can participate in annual meetings. The bondholders can, and should, take steps to keep themselves informed about the long-term outlook.

Methods of detecting failure tendencies. Trends toward failure may be detected by an analysis of data coming from within the business itself, or from outside sources. Technically we call the former the *internal method*, the latter the *external method*.[11] Outside sources include trade reports and statistics, and economic indicators published by the Federal Government and by private organizations.[12] It is not difficult to collect this material or for a trained person to gather from it what professional economists and analysts regard as the strong and weak points in general business conditions. In many of the external sources trends are clearly indicated. Taken alone, the internal analysis is perhaps of greater value. However, the results of a complete study employing both approaches will provide the analyst with the only reliable indicator of the concern's strength or weakness.

An analysis of the financial statements of the corporation over a period of years forms the basis of the internal method (see Chapter 18). The general procedure is to compare the balance sheets and the income statements over a period of several years so that trends may be noted. If a more sensitive analysis is required, quarterly statements rather than annual statements should be used.

A study of balance-sheet trends will generally reveal the following failure tendencies:

1. Insufficient working capital. This as well as other trends is more easily noticed if the items on the balance sheet are reduced to a comparative trend analysis utilizing a base period as 100 per cent. In analyzing the working capital position it is apparent that comparative changes in dollar figures can be more effectively comprehended in terms of percentage ratios than in actual dollars. For example, a change from 100 per cent to 75 per cent can be more readily visualized than a change in multiple-digit figures from $9,875,439.80 to $7,406,579.85. The use of these trend percentages has the effect of exaggerating the comparative changes in dollar figures, thus emphasizing the failure tendencies. It is extremely important that in drawing conclusions, trends and the relationships between the various items of the balance sheet and the income statement be analyzed for conformations or disparities, and the careful analyst will soon appreciate

[11] An excellent example of internal detection of failure tendencies is available in *Fundamentals of Investment Banking*, sponsored by the Investment Bankers Association of America (Englewood Cliffs, N. J.: Prentice-Hall, Inc., 1949), Chapter 14, pp. 432–438, by Dr. Louis P. Starkweather.

[12] The *Survey of Current Business* and the *Federal Reserve Bulletin* are U. S. Government publications of inestimable value for studying the general situation. Trade magazines like *Iron Age* furnish general information on specific industries. Services like *Prentice-Hall Information* news letter give current information of value.

the significance of the interrelationship of these comparative financial statement failure tendencies.

2. Weak cash position.
3. Overinvestment in receivables.
4. Overinvestment in inventories.
5. Excessive or overvalued fixed assets.
6. Excessive bank loans and current liabilities.
7. Burdensome funded debt and fixed liabilities.
8. Overcapitalization.

The following changes in income statement items may disclose additional failure tendencies such as:

1. Declining sales.
2. Increasing costs and expenses such as labor, cost of goods sold, overhead, and the like.
3. Excessive selling and administration expenses.
4. Burdensome interest or other fixed charges.
5. Excessive dividends or withdrawals.

All leading to:

6. Declining net profits and a lower rate of return on invested capital.

This method of comparative trend analysis for the detection of internal causes of failure by no means exhausts the analytical methods available for further study. It does, however, furnish a starting point, and the careful analyst will soon find other internal as well as external relationships of further significance.

Problems

1. Using stocks traded on the New York Stock Exchange, (a) prepare a list of stock splits that took place last year, (b) give at least five recent examples of stock dividends and find out how they were reflected on the balance sheet.
2. The Able Company is in arrears on its preferred stock. Mr. Baker, one of of its directors, proposes that the company recapitalize. Its balance sheet is as follows:

Cash	$ 1,000,000	Accounts payable	$ 3,000,000
Accounts receivable	500,000	Preferred stock (6% cum., non-callable, 100,000 shares at $25 par)	2,500,000
Inventory	3,500,000	Common stock (800,000 shares at $10 par)	8,000,000
Plant and equipment	8,500,000	Capital surplus	2,000,000
Goodwill	2,000,000		
	$15,500,000		$15,500,000

The preferred arrears are $750,000. Earnings this year are $700,000 and expectations are they will be at least that much for the next five years.

(a) Would you, as a preferred stockholder, agree to a plan that would eliminate the arrearages, reduce the preferred to $20 par at 5 per cent, and give the preferred stockholders one share of common for each share of preferred?

(b) Would you, as a common stockholder, agree to this plan?

CHAPTER 27

Corporate Reorganization and Liquidation

Introduction. In the previous chapter we discussed several important causes of business failure. We also addressed ourselves to alternative changes in capital structure which may result from voluntary acts on the part of management and security-holders. In this chapter we shall examine certain debt and equity changes that take place under the jurisdiction of a court. The reader might ask the question at this juncture, "Under what circumstances do we have a readjustment? Under what circumstances do we have a reorganization?" In the preceding chapter we explained the difference between failure in the business sense and failure in the economic sense. This distinction, for the most part, now serves as a line of demarcation to separate the two procedures. Many financial writers have drawn a distinction between failure in the business sense, which leads to reorganization or liquidation, and failure in the economic sense, which leads to readjustment. The difference may be academic in nature, but it serves as a benchmark for discussion and explanation.

Since the history of our Bankruptcy Act is replete with amendments, we shall consider the changes wrought by legislative acts beginning in 1933. As a prelude to these amendments an explanation of the equity receivership procedure seems appropriate. In our discussion we shall consider:

1. Equity receivership and reorganization
2. Section 77B, passed in 1934
3. Corporate reorganization under Chapter X of the Bankruptcy Act
4. Arrangements under Chapter XI of the Bankruptcy Act

5. Railroad reorganization pursuant to both Section 77 of the Bankruptcy Act and the Mahaffie Act
6. Voluntary or involuntary bankruptcy liquidation

History of bankruptcy laws. As far back as ancient Rome, people were trying to find a solution for the bankruptcy problem. Although they did not solve the problem, the Romans did crystallize their thoughts in the first bankruptcy law in 313 B.C. England did not enact a bankruptcy law until 1542. This law, however, bears little resemblance to our present statute. It was enacted solely for the benefit of creditors; debtors were still regarded as being virtually criminals. Discharge of the debtor from his debts did not come in England until 1705, almost two hundred years later. In the American Colonies the question whether matters of bankruptcy should reside in the proposed Federal Government or in the state governments was vigorously debated. Although the right to make laws affecting bankrupts was finally delegated to the Federal Government, so intense was the feeling against it in many states that during the period between 1800 and 1900 national bankruptcy laws existed intermittently for only about 17 years. The first bankruptcy act, which was enacted in 1800 and lasted two years, was limited in scope to traders, merchants, and brokers. The second bankruptcy act, dated 1842, lasted the same length of time. The third bankruptcy act in 1867 managed to exist until 1878. Incidentally, it was the first bankruptcy law to govern certain classes of corporations. The depression of 1893 was largely responsible for the enactment of the Bankruptcy Act of 1898. This Act, although amended several times, was finally replaced by the Bankruptcy Act of 1938, commonly referred to as the Chandler Act.

It is interesting for the student of finance to note how the economic philosophy with respect to bankrupts has changed in the years since the first English bankruptcy act, and how these changes have influenced financial management. The first law was enacted for the benefit of creditors. In 1705 the debtor's plight was recognized and discharge of debts was provided. That the public, through the medium of service enterprises like railroads and public utilities, had an interest in bankruptcy proceedings does not seem to have been realized until 1933, when Section 77 was added by amendment to the 1898 Act. This section permitted the reorganization rather than the liquidation of railroads. Although it is true that as far back as 1867 equity receivership could result in the reorganization of a debtor concern, the object was basically the protection of the creditors and not the stockholders.

Need for preventing haphazard seizure by creditors. Before we proceed to describe the methods of reorganization, we must pause to explain the need for protecting property against haphazard seizure by creditors.

Fundamentally, all persons interested in a business are either owners or creditors.[1] If creditors wish to enforce their rights by seizing property, they must establish themselves as creditors in a legal way. Either they must prove that they have a lien of some kind—usually a mortgage—or they must reduce their claim to judgment by bringing an appropriate action. Since a judgment constitutes a lien against the property of the judgment debtor, we may say that creditors ordinarily cannot force action until they have a lien. But when they do have a lien securing a past-due debt, they may cause the sheriff or other legal official to seize and sell any property on which the lien rests. If, for example, *A* obtains a judgment against the *X* Company for $10,000, *A* may cause the sheriff to seize enough property to satisfy the claim and cover all expenses.[2] But if the property of a large business is seized and liens are foreclosed, the unity of the business property will be broken up and the business will lose not only the value of the bare property but also the value of the organization as a whole, which depends upon the use of all the property. Moreover, the property sold at a forced sale would not yield nearly as much as it cost, and the fact that the business was being disorganized would frighten customers into believing that the quality of products and service would be lowered. The only way to prevent this train of unfortunate results is to protect the property against haphazard seizures and to undertake a thoroughgoing reorganization that will yield an efficient business, one that can inspire and retain the confidence of creditors, stockholders, labor, and customers.

Equity receivership and reorganization. Although prior to 1933 the Bankruptcy Act did not include any provisions for the reorganization of a business corporation, a procedure did exist in both the Federal and state courts for reorganizing rather than liquidating a concern that had failed in the sense that it couldn't meet its obligations as they matured, but that gave promise of future profit under a reorganized management with favorable economic conditions. The system of judgments mentioned in the preceding paragraph gave to the most cold-blooded and to the swiftest the advantage over the creditor who was inclined to give the debtor a second chance to work out its future. The development of receivership in an equity court was a legal attempt

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[1] It is hardly necessary in a book of this kind to make the nice distinctions between the relation of creditor and debtor, the relation of trustee and beneficiary, and other relationships, that would be made in an exhaustive legal text. The statement in the text is substantially true.

[2] It is hardly necessary to add that a judgment is no better than any other lien and that if property on which a prior lien rests is seized to satisfy a judgment, the property must be sold subject to the prior lien; which means that the purchaser at the execution sale would get only an equity in the property, worth the difference between the total value of the property and the amount of the debt secured by the prior lien.

to correct this economic waste. It must be remembered, however, that equity reorganization had as its principal object the protection of all creditors by preventing the dissipation of the assets and going-concern value through preferences and priorities in judgments and attachments. Reorganization of the debtor was a secondary objective. This objective differs from that of present-day bankruptcy reorganization, as we shall see later.[3]

The equity proceeding was usually commenced by a "friendly" creditor who petitioned the Federal equity court in the district where the principal assets of the debtor were located to appoint a receiver of the property of the debtor.[4] The petition alleged, among other facts, that the debtor was unable to meet its debts as they matured, that other creditors had secured judgments, or were about to secure judgments. The court, if it approved the petition, appointed a receiver who took title to the property and attempted to effect rehabilitation.

The creditors were divided into various classes by rules that we need not discuss. Usually each class formed a protective committee to represent it in all proceedings and to protect its interest. These committees in turn formed a joint reorganization committee whose function it was to formulate and submit an over-all plan of reorganization acceptable to those concerned. The plan usually involved the sale of the debtor's property at a foreclosure sale to an interested group, the organization of a new corporation to take over the property, the raising of cash with which to pay off the dissenters to the plan, and the issuance of securities of the new corporation in exchange for those of the old company to creditors and stockholders who agreed to the plan. The formalities attending the voting on the plan and the execution are of more interest to the law student than to the finance student.

The foreclosure sale was a formality and the only bidder was usually the interested group. A minimum price at which the debtor's property could be sold at foreclosure, known as the "upset price," was established by the court. In fact, the equity court conceived its chief func-

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3 Since the enactment of Sections 77 and 77B and Chapters X and XI of the Bankruptcy Act, equity receivership as a method of reorganizing a business enterprise has been used less frequently. However, when any property is in danger of depreciation or of loss in value because of disputes or litigation, any person interested may petition a court of equity—either state or Federal, depending upon which has jurisdiction—to take care of it until it can be liquidated or properly administered without the aid of a court. Equity receivership may be resorted to when the debtor's assets exceed his liabilities but he does not have funds to meet current obligations.

4 A receiver is an officer of the court who holds property for the court and attends to the details of management pending final disposition of the matter before the court. While the receiver holds the property, no person can proceed against it without the consent of the court. Thus, a receivership effectively prevents the dissipation of property through haphazard seizures.

tion to be the determination of the upset price. It was determined only after months, and sometimes years, of evaluating all of the debtor's property. The methods employed and the formulae used in arriving at the upset price present an interesting study in valuation. Since this method of reorganization is largely obsolete, a detailed discussion of how the price was determined need not be made. In general, the court considered the original cost less depreciation, replacement cost, book value, and, to a lesser extent than present-day courts, the earning capacity. Of necessity, the upset price had to be low enough for the purchaser to make a success of the business, yet high enough to prevent a successful challenge on appeal by the creditors.

The equity procedure introduced a method of realizing the maximum amount from the sale of the debtor's assets for the benefit of all of the creditors by providing for the sale of the debtor concern as a going business, at a predetermined price. Under the previous practice, it will be recalled, creditors obtained judgments at law and the debtor's assets were sold piece by piece to satisfy the judgments. Unfortunately, however, the equity procedure provided no means of forcing a recalcitrant minority to join with the majority in the acceptance of the plan. Whether this hostility was real or feigned made no difference. The more common procedure was to acquire the recalcitrants' consent through "horse trading," or, as was often necessary, to buy them out. This drain on the cash position of the new company often jeopardized whatever chances it had of succeeding. The lack of control over recalcitrants was one of the defects of the equity proceeding; others are discussed below.

Defects of equity receivership. In addition to the defect noted above, there were several others, all serious. *First,* to obtain control over assets situated in Federal districts other than the one in which the petition was filed, ancillary receivers had to be appointed by the court in that district. An ancillary receiver is one appointed in a foreign jurisdiction for the purpose of taking charge of the assets in the jurisdiction where he is appointed. The receiver appointed by the court in which the proceeding is instituted has jurisdiction only within the territorial limits of the court as prescribed by law. Sometimes the local court would appoint the receiver named by the original court, but more often it would appoint a local receiver. As a result, there was no chief executive steering the reorganization through the many steps leading to final consummation. Some of the ancillary receivers unfortunately could be expected to favor the local creditors at the expense of the over-all plan.

Second, the court had no power to displace liens already in existence. The receiver whose function it was to operate the business during the court action was therefore seriously hampered in his efforts to raise

funds with which to carry on day-to-day operations. Receiver's certificates [5] are made legally prior liens; otherwise, they would be practically unmarketable. *Third,* the court had little, if any, control over the protective committees. It was more or less common knowledge that abuses existed in the conduct of these committees, but it was probably not until investigation was made by the Securities and Exchange Commission, and its report made public, that the extent of the injury to investors and the public was realized. Committees which were supposed to mobilize security holders for group action in the interest of the group were frequently formed, controlled, and used instead by insiders to protect or further their own interest. Fees and expenses were exorbitant. *Fourth,* receiverships were often protracted affairs, sometimes lasting more than 25 years. *Fifth,* the length of time necessary to complete the process resulted in heavy expenses. Ancillary receivers had to be compensated; legal counsel to the receivers required money. Added to this, the necessity of getting a high percentage of agreement to any proposed plan inevitably meant delay and additional expense. *Sixth,* the court had little, if any, control over the plan of reorganization. This perhaps was the chief drawback of the equity receivership. At times the plan was formulated by the bondholders, acting through their committee. If this group happened to be more powerful than the stockholders' committee, the bondholders were treated proportionately more favorably than their position warranted. If, on the other hand, the stockholder or management group sponsored the new corporation, that group often received better treatment than did the mortgage bondholders. The doctrine of absolute priority, yet to be defined accurately, was not always strictly adhered to. *Seventh,* no provisions were made for acquiring additional capital. In many cases it was difficult to know just how much would be needed to carry the reorganization plan into effect. The problem of finding the funds to pay the dissenting minority, as well as of providing and maintaining sufficient circulating capital, was constantly present. Despite these defects, equity receivership played an important role in the economic reconstruction of corporations from 1867 until 1933. The weakness in this method, however, had then become so serious that corrective legislation had to be undertaken.[6]

Changes in the Bankruptcy Act to correct defects in equity receivership. *Section 77B.* Enacted in 1934, Section 77B did much to improve the situation in the area of reorganizations. The amendment applied to business corporations, with certain types excepted, for example, railroads, insurance, banking, building and loan associations, and

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[5] Explained at page 137.

[6] See James M. Rosenberg, "Reorganization Yesterday, Today, Tomorrow," 25 Va. L. Rev. 129–164, containing a review of reorganization procedure.

municipal corporations. Since bankruptcy legislation in the United States had in the past been used primarily to liquidate the assets rather than to reorganize the debtor, it seemed less difficult on constitutional grounds to amend the Bankruptcy Act than to pass an entirely new law.

Section 77B was prepared and passed in a rather hasty fashion to aid in the recovery program then being promoted. Little information was available on actual abuses occurring in reorganizations and liquidations. It was apparent that much work would be necessary before any further amending should be attempted. The Securities and Exchange Act passed in 1934 included a section directing the Commission to make a study of protective and reorganization committees with a view to submitting a report to Congress. Chapter X of the Chandler Act was in the main based upon their findings and the experience acquired under 77B.

The Chandler Act. Passed in 1938, the Chandler Act supplanted Section 77B. It provides for two types of reorganizations. The larger corporate enterprises that have securities in the hands of the public are usually reorganized under Chapter X. Small firms with unsecured bank and merchandise creditors find it simpler to effect an arrangement under Chapter XI. In addition, the Chandler Act corrected a defect that existed in both the equity receivership and Section 77B. In neither proceeding was there provision for a disinterested analysis of the causes of failure or for an appraisal of the integrity and capacity of the management. Nor was there any provision made for securing independent advisory aid to determine whether the plan of reorganization finally proposed was feasible and fair to all concerned. Chapter X provides that in certain instances, which we shall discuss later, the Securities and Exchange Commission shall perform these services.

Steps in industrial reorganization under Chapter X. The Bankruptcy Act prescribes certain steps in the orderly procedure of reorganization pursuant to Chapter X. They are, in chronological order, as follows:

1. Filing a petition in Federal court
2. Appointment of a disinterested trustee by the court if it entertains jurisdiction
3. Preparation of a plan of reorganization by the trustee
4. Hearings on the plan before the court
5. Advisory report on the plan prepared by the Securities and Exchange Commission
6. Court approval of the plan
7. Voting on the plan by the creditors and stockholders affected
8. Confirmation of the plan by the court and execution of the plan by the trustee

Initiating the reorganization. Reorganization proceedings are initiated in the jurisdiction of the debtor's principal office—not necessarily its corporate office. The proceedings apply to all of the corporation's assets, wherever located, thus eliminating the need for ancillary actions.

Any corporation, industrial or public utility, other than a railroad, municipal corporation, bank, or building and loan association, may initiate a voluntary proceeding under Chapter X of the Chandler Act. An involuntary proceeding may be instituted by three or more creditors who have claims against the corporation or its property which amount in the aggregate to $5,000 or more. A trustee under a mortgage, deed of trust, or indenture under which there are securities outstanding may also file an involuntary petition without the co-operation of any of the corporation's creditors, if the securities outstanding are "liquidated" as to amount, that is, a fixed and agreed sum and not contingent as to liability. The trustee may also bring suit on any violation of the deed of trust or indenture. No one may file a petition if one has already been filed by or against the corporation.

The petition, whether voluntary or involuntary, must contain certain matters prescribed by the statute and must state why adequate relief cannot be obtained under Chapter XI of the Bankruptcy Act, dealing with "Arrangements," explained at page 551. The corporation may file an answer controverting the facts alleged in an involuntary petition. Individual creditors, indenture trustees, and stockholders, regardless of the size of their claims or holdings, may answer a voluntary or involuntary petition, contradicting the allegations in the petition. If the petition complies with the law, and has been filed in good faith, the judge must approve it. If the petition is contested, the judge must be satisfied that the material allegations in the petition are proved. The statute contains certain provisions to aid the judge in determining when a petition is filed in good faith.

Upon the approval of a petition, the judge must appoint one or more disinterested trustees in every case in which the debtor's liquidated and non-contingent indebtedness amounts to $250,000 or more. Where the indebtedness is less than this amount, the judge may continue the debtor in possession, or he may appoint a disinterested trustee if deemed desirable under the circumstances or in the public interest. To be "disinterested" a trustee cannot be (a) a creditor or stockholder, (b) an underwriter of any of the securities of the corporation, (c) an officer, director, or employee of the corporation within the past two-year period, or (d) have any other interest that might be adverse to the interest of any class of creditors or stockholders. In addition to appointing a disinterested trustee, the judge may also appoint a director, officer, or employee of the debtor as a co-trustee for the purpose

of operating the business and managing the property of the corporation.

Procedure relating to plans. Within a period of time fixed by the judge, the trustee must prepare and file a plan, or must report the reasons why a plan cannot be effected. He is charged with the responsibility of discovering the cause of difficulty and of encouraging the preparation of reorganization plans by the various classes of creditors, bondholders, and stockholders, as well as suggestions and proposals leading to the development and construction of the trustee's plan. He is aided in the preparation of the plan by suggestions and proposals submitted by the creditors and stockholders. In fact, the trustee is required to give notice to the creditors and stockholders that they may submit to him suggestions for the formulation of a plan, or proposals in the form of plans. Committees representing each class of creditors and stockholders are formed. The corporate trustee for a bond issue usually works with the various bondholder committees in an effort to present a plan of reorganization agreeable to all the bondholders and to the trustee appointed by the court. Committees representing the unsecured creditors and committees representing the several classes of equity holders work independently because their interests are adverse.

A hearing is held on the trustee's plan, at which objections may be considered or new proposals may be submitted by any creditor, bondholder, or stockholder of the corporation. Any plan that the judge regards as worthy of consideration may be submitted to the Securities and Exchange Commission if that agency is an interested party.[7] After the Commission has rendered its advisory report, the judge may approve any plan that in his opinion complies with the law and is fair, equitable, and feasible. No more than one plan at a time may be approved and submitted to the creditors and stockholders for their consideration, but no solicitation of acceptances of any plan may be made unless the plan has been approved by the court. A time is fixed within which the creditors and stockholders affected by a plan may accept it. The acceptance by two-thirds in amount of each class of creditors whose claims have been allowed and, if the corporation is not insolvent, by a majority of the stockholders of each class recognized under the plan is necessary before any plan can be confirmed and carried into effect. After the requisite acceptances have been filed, the plan is confirmed at a hearing. It is carried out subject to the court's supervision and control and is binding upon dissenting creditors and stockholders.

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[7] The role of the Securities and Exchange Commission in reorganization is discussed more fully at page 548.

The plan of reorganization. Before attempting the cure, the causes of the ailment must be ascertained. The first step in drafting any plan of reorganization, therefore, is a thorough analysis of the business and, particularly, of the causes of failure. A complete audit of the books for a period of several past years should be made by a firm of accountants and the results examined. Substantial revisions in certain items appearing on the balance sheet may be necessary. Goodwill, patent rights, copyrights, and other intangibles may be carried at figures representing far more than they are worth. For example, if asset values are inflated as the result of inadequate depreciation policy in the past, a drop in the market value, or some other cause, the fictitious portion may more than offset the amount of the reserves. Inventories may be obsolete or difficult to dispose of. Accounts receivable may be old and uncollectible or not adequately covered by the reserve for bad debts.

The second step is to make a complete survey of the debtor's physical plant. This should take two forms. There should be a complete analysis of the existing plant to assist in determining, among other things, (1) whether or not the plant is obsolete, (2) the amount of repairs necessary to restore the plant to efficient operation, (3) which units, if any, should be abandoned, and (4) what new units would be necessary to maintain a competitive position in the industry. Coupled with this survey of the debtor, an over-all analysis of the industry itself and its future potential should be made. There is little practical use in rebuilding a corporation in an industry already on the wane, or in attempting to compete in a highly competitive industry with a worn-out plant. This is especially true if the sale value exceeds the estimate made of going-concern value. Such circumstances could lead to a reorganization plan calling for liquidation of the debtor firm in whole or in part, or to its being adjudged bankrupt by accepting a petition of bankruptcy to supersede the Chapter X action.

The third step, but by no means the last in point of time, is the combined legal and financial analysis. The claims against the corporation, the contracts, leases, and other obligations, as well as the tax structure, must be examined. A plan for securing the funds necessary to place the concern in running order again must also be formulated at this time.

After the trustee and those concerned are satisfied that the venture can be reorganized into a healthy and profitable enterprise, and after extensive rehabilitation has been undertaken during the period of trusteeship, work is begun on a plan of reorganization.

That the preparation of an acceptable plan of reorganization is a long process may be seen from a few examples. The Radio-Keith-Orpheum (RKO) reorganization extended over a seven-year period from 1933 to 1940. The Chicago, Milwaukee and St. Paul Railroad

took twelve years, from 1935 to 1947. The Missouri Pacific Railroad reorganization was commenced in 1933 and was finally completed in 1956. On the other hand, simple industrial reorganizations have been accomplished within a short period. The Baldwin Locomotive Works filed a petition for reorganization in March 1935, and by September 1937 the reorganization had been accomplished.

Mandatory provisions of a plan. The law prescribes certain provisions that must be included in every plan of reorganization and indicates others that may be included. The following are the mandatory provisions:

1. Alteration or modification of the rights of creditors generally or of some class of them. Provisions may be included altering or modifying the rights of stockholders, as a whole or by class.
2. Payment of all costs and expenses of administration and other allowances approved or levied by the court.
3. List of claims, if any, that are to be paid by cash in full.
4. List of claims or stock not to be affected by the plan, and provisions, if any, with respect to them.
5. Treatment of any class of creditors affected by the plan where two-thirds of such class fail to accept the plan.
6. Protection of the interests of non-assenting classes of stockholders, if the debtor is deemed to be solvent.
7. Adequate means for the execution of the plan, if necessary through transfer of the property to a successor corporation or by merger, or consolidation with other corporations, or any one or more of a number of other general methods as stated in the Act.
8. Provisions relating to executory contracts, their rejection, and proper exceptions.
9. Provisions with respect to the manner of selection of officers, directors, or voting trustees that are equitable and compatible with the interests of creditors and stockholders and consistent with the public interest.
10. Provisions in the charter of the corporation, or of any successor corporation, prohibiting the issuance of non-voting stock and insuring the fair and equitable distribution of voting power among the various classes of stock. In the case of preferred stock, adequate provision must be made for the election of directors representing such preferred stock in the event of default in dividends.
11. Fair provisions with respect to the terms, position, rights, and privileges of the several classes of securities.
12. Provisions in the charter requiring the issuance of financial statements annually to security holders, if the indebtedness is at least \$250,000.

Sacrifices made in a typical reorganization. In most reorganizations, changes are made in internal organization. More important changes, however, are made in the claims against the property. Every claim against the property may be analyzed as follows:

1. Amount of principal
2. Legal precedence of principal in claim on assets
3. Amount of interest or dividends
4. Precedence of interest or dividends in claim on income
5. Property of company against which principal and income have a claim

The law gives certain creditors, even though they are unsecured, a right to prior payment. They are the United States, a state, or political subdivision, for taxes; certain employees, for wages earned three months prior to the start of proceedings; and the trustee or receiver for debts and expenses that have been approved by the court. These creditors are generally paid off during the period in which the court has jurisdiction of the debtor's property. If such is not done, the plan of reorganization must provide for their payment. The priority of claims following the preferred group depends essentially on the legal positions they occupy, as follows: holders of trustee's certificates,[8] the senior mortgage bondholders, junior bondholders, divisional or subsidiary company bondholders, unsecured creditors without preference, preferred stockholders, and common stockholders.

The net result to the company of all the sacrifices that the security holders are called upon to make must be: (1) the provision of an adequate amount of cash for the needs of the reorganized company; (2) the elimination of floating debt; (3) a reduction of the fixed charges to an amount that can quite certainly be met year in and year out; and (4) the creation of a stock issue. This issue should not be too large, but should be of a size that will permit the holders of it to derive some income through it from the earnings left after the payment of the fixed charges. In general, the financial problems of those undertaking the reorganization are (1) to submit a plan with a reduced capitalization of which as small a part as possible shall be bonds, and (2) to provide sufficient cash for working capital and other necessary purposes to permit continuation of the business. To accomplish these general purposes, the several classes of security holders may be asked to make one or more of the following sacrifices:

1. Payment of assessment; this is not commonly required today.
2. Reduction in amount of principal; a preferred stockholder, for

[8] Chapter X of the Bankruptcy Act provides that the judge, upon application of the trustee, may authorize the trustee to issue certificates having a lien prior to existing certificates for the purpose of raising funds for the ordinary operation of the business or for necessary capital improvements.

Unfortunate results, however, have occurred as a result of the harsh application of this rule. The absolute priority rule may be applicable if the plan calls for liquidation of the assets, but it is quite another thing when applied to the reorganization of a concern. In liquidation the assets bring a definite amount when sold, while the value of a going concern is generally uncertain. The absolute priority rule makes it extremely difficult for stockholders to participate in any plan of reorganization. Once the plan of reorganization is approved, any development of unforeseen profitability is entirely lost to the former stockholders. The increased use of some form of contingent participation for the old shareholders may alleviate the harshness of this rule. Stockholder participation depends, in most instances, upon the value placed on the assets of the debtor, the value being settled on the basis of capitalization of earnings. In 1941 a case arose in California which reached the Supreme Court of the United States for final determination.[11] The absolute priority rule was stated in this case in definite terms. The decision, however, included several additional comments leaving doubt as to the application of the rule. Among the pronouncements in this case was the use of earning power as the basis for valuing the assets of the debtor. A tenuous method of valuation was made the basis for determining the right of stockholders to participate in the reorganization.

Although the senior class must be paid in full to the extent of its participation, this payment may take the form of securities in the newly formed organization instead of cash. The allocation cannot be a matter of rigid formula but necessarily varies from case to case. All who have a part in the preparation of the plan are bound to conform to these tests and cannot, even by agreement among themselves, circumvent its basic provisions in any manner whatsoever.

Treatment of stockholders. As previously indicated, in reorganizations under Chapter X of the Bankruptcy Act, all classes of security holders who are recognized under the absolute priority rule must be given consideration. The result is a tendency toward harsher treatment of stockholders. An effort is usually made to give the old stockholders some interest in the reorganized company, even if it is only a warrant to purchase some of the corporation's new securities in the future, or a right to subscribe to stock of the new company. The SEC and the courts frown on such warrants, since all new stock must be distributed to the old security holders.

Under the old equity reorganization procedure and prior to the enactment of the various reorganization chapters and sections of the

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[11] Consolidated Rock Products Co. et al. v. Du Bois, (1941) 312 U.S. 510, 61 S. Ct. 675. See also H. G. Guthmann, "Absolute Priority in Reorganization," *Columbia Law Review*, September, 1945, pp. 739 ff.

Bankruptcy Act, plans of reorganization generally included an assessment upon the common and preferred stockholders to provide needed cash.[12] If the stockholders paid the required cash, they were given stock in the new company in proportion to their holdings of old stock—usually, dollar for dollar. The assessment method of providing cash for the rehabilitated company is seldom resorted to in present-day reorganization plans. The amount of cash required from the common stockholders is generally larger than that demanded from the other security holders. In almost all instances where new cash is put into a reorganized company, the contributors get for this cash the best form of security that the company can provide. When an assessment is used, it merely "permits" the old stockholders to buy securities in the new company. The payment of the additional sums results not only in the purchase of stock in the new company, but a retention of their equity position in the enterprise.

The preferred stockholders are not the residual participants in the ownership of the company, as are the common stockholders, and may enjoy a strategic position in the reorganization negotiations. This may be true since preferred stock is generally given a preference as to assets on liquidation. Generally, a corporation that is unable to pay its debts as they mature will have little equity remaining for the stockholders to use. Under the doctrine of "relative priority," used in the old equity reorganization procedure, no attempt was made to place a value on the assets of the enterprise to permit stockholders to participate. The application of the legal doctrine of "absolute priority" requires each class to be satisfied in full before any junior security holder may participate. In many respects the old security holders are handled much the same as if a liquidation had occurred. They are paid in the new securities of the reorganized company instead of in cash.

In some industrial companies, one of the difficulties has been to eliminate the accumulations of dividends on cumulative preferred stock. The preferred stockholders cannot be expected to surrender their arrearages gratuitously. They may have one of two alternatives: (1) accept securities for the arrearages—that is, the arrearages may be capitalized; (2) accept securities with participating or convertible features and with a higher rate of dividend but without the cumulative feature—that is, exchange a degree of certainty for a chance of greater income.

General creditors. The general creditors are those who have no specific liens on the company's property. If a creditor has a specific

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12 Although cash was not a problem, see the McKesson & Robbins case, where additional cash was acquired from the sale of the Hunter Baltimore Distillery.

lien on property, his position in the reorganization will depend not only on the priority of his lien, but also on the value of the property to the company. If he has no lien at all, he is a residual claimant coming in ahead of the owners or stockholders. General creditors usually retain their status, with perhaps some reduction in their claims or the award of serial notes.

Position of bondholders in reorganization. The success of the maneuvers for favorable position in the reorganized company by the committees representing the bondholders will depend not only on the lien positions of the bonds they respectively represent, but also on the value to the new company of the properties on which the bonds rest. The situations in which committees may find themselves may be divided into the following classes:

1. Underlying mortgage on underlying strategic property
2. Underlying mortgage on less strategic property
3. Senior mortgage on the main property
4. Junior or refunding mortgages on underlying strategic property
5. Junior or refunding mortgages on less strategic property

Looking at the problem of the corporation itself, the point of departure is the value of the respective properties to the new organization. When this is determined, the next step is to deal with groups who have interests in those properties, with due regard to their legal position.[13] The simplest problem is the treatment of those holding claims exclusively on less vital properties. If the property is in effect a "white elephant" that cannot be operated except at a loss, the reorganizers should take the opportunity which their proceedings offer to "lop it off." [14] As a general rule, priorities are retained if possible. In the interest of simplification, a single, new issue may be exchanged for several old issues. An after-acquired clause may be employed with serial maturities to preserve the variations in the terms of the loan.[15] When mortgage liens are disturbed because earnings are deficient, the priorities are not easily preserved.

[13] The problem is not so simple as it is made to appear. "The problem of corporate reorganization is and has always been primarily a problem of how a corporate debtor in failing circumstances can be made economically sound, and at the same time the legal rights, insofar as they exist, of the creditors and stockholders be preserved under some sort of an arrangement fair to all." The reorganization of a corporation is not a mere law suit in the ordinary sense of an adversary action to settle issues between competing claimants; it is a conglomeration of legal procedure, corporation finance, management, and economic theory. *Collier on Bankruptcy*, Vol. 6, pp. 2–8, ¶ 0.01.

[14] The treatment of bonds resting on underlying properties does not depend to any great extent on the nature of the title which the corporation has to those properties. The title may be held directly—that is, the bond may be a "divisional" bond, in railway language—or it may be held through a subsidiary company arrangement.

[15] The problems involved in allocation of new securities for old ones are discussed in H. G. Guthmann, "Absolute Priority in Reorganizations," 45 *Col. L. R.* 739–754 (September, 1945).

We should observe, in passing, that in most reorganizations, simplification of the over-all capital structure is important and that the new company is likely to have few separate bond issues. If, for example, the old company had six issues represented by the classes enumerated above, the new plan might call for two issues—a first and second mortgage issue on all the property.[16] In such a case the holders of weak bonds of the old company would be given second mortgage bonds, and account would be taken of the relative weakness of the various issues of the old company by some adjustment of the amount of bonds offered.

The same general principles apply to the security holders who have claims on the underlying strategic properties. They will be asked to make small sacrifices, or they may be taken into the new company without any sacrifice whatever. Indeed, bonds secured by a first mortgage on a very strategic part of the property may come out of the reorganization in a better position than they went in. For example, the bonds may be low-interest-bearing bonds on which the interest was earned many times over. From an investment standpoint, these securities have a superabundance of lien safety at the expense of earning power. The holders, therefore, may be given an equal amount of par value of first mortgage bonds on the new property, bearing a higher rate of interest, reflecting, for the most part, changes in bond yields at the time of the plan. Bonds in exceptionally good position ordinarily are not affected by the plan. Much will depend on the need for cash. If the insolvency is so extreme that the stockholders can be given little incentive to participate in the reorganization, the bondholders, who now own the property, may have to provide some of the cash.

Leases and rental contracts. Difficult problems are often presented in the adjustment of legal claims arising under lease agreements. The trustee may continue the rental payments, or he may repudiate the contract and stop payment entirely. The power may seem arbitrary, but it is a necessary one. Since the trustee may bar the claims of bond-

[16] Justice William O. Douglas, in delivering the unanimous decision that set aside a plan of reorganization of Consolidated Rock Products Co., stated as follows: "If the creditors are adequately compensated for the loss of their prior claims, it is not material out of what assets they are paid So long as they receive full compensatory treatment and so long as each group shares in the securities of the whole enterprise on an equitable basis, the requirements of 'fair and equitable' are satisfied. Any other standard might well place insuperable obstacles in the way of feasible plans of reorganization. Certainly where unified operations of separate properties are deemed advisable and essential as they were in this case the elimination of divisional mortgages may be necessary as well as wise. Moreover, the substitution of a simple, conservative capital structure for a highly complicated one may be a primary requirement of any reorganization plan. There is no necessity to construct the new capital structure on the framework of the old." (Consolidated Rock Products Co. v. Du Bois, (1941) 312 U.S. 510 at 530, 61 S. Ct. 675 at 687.)

holders and other creditors, he cannot be forced to give preference to rental claims arising under long-term leases. The unexpired terms of the leases do, however, constitute unsecured claims against the debtor. If the trustee elects to retain the leases, he must of necessity pay the agreed rent. The trustee is required to deal with the leases during reorganization and has a great deal of discretion in deciding what he will do. The failure of large chain stores and other mercantile firms presents the problem of what to do with long-term lease agreements. The "value" of unexpired leases is not easy to determine. They do, nevertheless, take precedence for unpaid rent over any distribution to shareholders and cannot be ignored in the final plan of reorganization.

How drastic can a plan of reorganization be? The committees charged with the construction of a reorganization plan must always keep in mind that they are working out a compromise between what ought to be done and what can be done. A thoroughgoing surgical operation may be advisable, provided the patient can stand it. The question then arises: what can the patient stand? Any suggested plan must apply to each class of security the test of expediency: will these bondholders or will these stockholders see in the plan any encouragement to send good money after their bad money? For example, the common stockholders may be given warrants to purchase stock in the reorganized company. If the bondholders have made little sacrifice, and if the reorganized company is likely to have such a burden of fixed charges that the chances of dividends on the common stock are negligible, the common stockholder will probably prefer to count his old investment a total loss and to invest his money to better advantage elsewhere. Sad as it may be, some reorganizations consummated in the past were fundamentally defective in that through compromise the condition of overcapitalization was merely transferred from the debt section of the capital structure to that of equity, through the issuance of warrants or stock far in excess of sound estimates of past, present, and future earning power.

The Securities and Exchange Commission and the plan of reorganization. Chapter X placed an additional responsibility on the Securities and Exchange Commission. The Commission, at the request of the court, or on its own initiative if the court approves, may be made a party to any reorganization proceeding for the purpose of furnishing independent expert advice. In cases where the indebtedness exceeds $3,000,000, the judge must request an advisory report from that agency with respect to the plan of reorganization. If the indebtedness is less than that amount, he may nevertheless request such a report. The Commission does not hold its own hearings (as does the Interstate Commerce Commission in railroad reorganizations, for example)

but acts in a purely advisory capacity. There is no compulsion on the court to accept a recommendation of the Commission, although there should be good reason if the court ignores the recommendations of this group of experts. The Commission becomes a party to the proceedings and receives copies of all papers filed with the court. It does not have the right of appeal, however. One result of this participation has been to achieve some measure of uniformity in the administration and interpretation of the bankruptcy law throughout the United States. In the year ending June 30, 1956, the Securities and Exchange Commission had participated in 33 reorganization cases involving 52 companies with total stated assets of $455,136,000 and total stated indebtedness of $324,036,000.[17] The above information indicates the size of the Commission's responsibilities under the Act.

The Commission does not generally enter the proceedings until the court approves the petition for reorganization. The Commission does not have to wait for such action if it deems it proper to appear earlier.

As soon as the Commission becomes a party to the reorganization, it makes an analysis of the debtor along the lines set forth at page 540, covering the physical and financial condition of the company, the reasons for the financial difficulty, the quality of its management, and the value of its properties. As a party to the proceedings, the Commission is represented at all the hearings by its staff of experts stationed nearest to the court in which the proceedings are being held. In addition, the Commission takes part in informal conferences with the attorneys for the various parties and renders what aid it can in an endeavor to arrive at a workable plan and a solution to the difficulties that beset the debtor.

In working out the plan of reorganization, the Commission must test it against the requirements of fairness and feasibility, which we discussed above.

Not the least among the duties of the Commission is its activity with respect to the work of the various protective committees and the allowances granted to these committees by the court. The provisions of Chapter X were designed to permit the security holders to exercise their own judgment, based on all the information available in the proceeding, and to overcome the faulty tactics of protective committees previously noted. These committees often high-pressured security holders into voting on the basis of inadequate information. The Commission likewise tries to secure a limitation on the amount that will be allotted as compensation to committees. Much of the work of committees is a duplication of work already performed either by other

[17] Securities and Exchange Commission, Twenty-second Annual Report for the Fiscal Year Ended June 30, 1956, p. 172–3.

committees, by the trustee, or by the Commission itself. Some of these committees are formed, not because there is any real need for them, but rather because attorneys and others see a means of collecting substantial fees. The Commission is able to bring an impartial and objective view to all proceedings. This is true mainly because the Commission receives no allowances or payments from estates in reorganization. The Commission is, therefore, in a position to protect those who might deal in the securities of this company in the future, as well as the parties in all proceedings before the court.

Confirmation of the plan. After the Securities and Exchange Commission renders its report on the plan submitted to it, the court—if in its judgment the plan is fair to all concerned—approves it and sends it to all parties concerned so that they may vote upon it. The voting is conducted under the supervision of the trustee. The judge in rendering his opinion must find the plan (1) fair and equitable to creditors and shareholders, (2) feasible and practical, and (3) in agreement with the provisions of the Bankruptcy Act.

The judge sets a time within which the interested parties must act. He also decides into which class the parties fall, as they vote by class on all plans submitted. The judge then submits to all persons affected by the plan (1) the opinion of the judge on all plans approved by him, (2) the report of the SEC, if any, and (3) any additional material he deems pertinent to the case. When two-thirds of any class of creditors vote in favor of the plan, the remaining one-third are bound and must go along with the plan. In the case of stockholders, a majority can bind all where the corporation is solvent. If it is insolvent, they have no vote. If the plan is approved by the necessary vote, that fact is reported to the court, the court confirms the plan, and it is put into execution.

The need for money. Money may be required to provide working capital, to make needed improvements of plant and equipment, to pay expenses of reorganization, and to pay taxes. The sources of such funds may be from the sale of unnecessary assets, sale of stock, a mortgage loan, earnings, or a voluntary assessment of stockholders. A corporation in the throes of reorganization will not enjoy a good credit rating. As such, the terms under which it will be able to borrow money will be rather poor at best. In a few instances underwriters have performed banking functions under these conditions. The success of a reorganization plan requires that it be executed in its entirety. If cash is a necessity, it must be forthcoming. The above sources may be found wanting. Under such circumstances underwriters may be employed to assure the success of the cash-raising program. The agreement may require the investment bankers to take up any securities that remain unsold, or, where shareholders decline to pay the assess-

ment, the underwriters may be permitted to pay the assessment and take the new issue.

Arrangements under Chapter XI of the Bankruptcy Act. The smaller corporations with few stockholders whose only problem is an adjustment of unsecured debts may be reorganized under Chapter XI of the Bankruptcy Act as amended in 1938 by the Chandler Act. The Supreme Court of the United States, in Securities and Exchange Commission v. U. S. Realty and Improvement Company, interpreted Chapter XI as in effect designed to apply to corporations ". . . where there are no public or private interests involved requiring protection by the procedure and remedies afforded by Chapter X." This section augments the various non-judicial methods of readjustment such as common law composition settlements, assignments for the benefit of creditors, development or creditor committee management, and friendly adjustments.

Procedure under Chapter XI. The corporation in financial difficulties files a petition with the proper court, stating that it is unable to pay its debts as they mature and setting forth the provisions of the arrangement proposed by it. The court may appoint a receiver of the property, if necessary, or, if a trustee has previously been appointed, the trustee may continue in possession. If no receiver or trustee is appointed, the debtor corporation continues in possession of the property. The court is required to call a meeting of creditors upon at least ten days' notice by mail to the corporation, the creditors, and other interested parties. This notice contains a copy of the proposed arrangement, as well as a summary of the balance sheet of the corporation. At the meeting, the judge or referee receives proofs of claims and allows or disallows them; he also examines the debtor, hears witnesses, and receives the acceptances of the proposed arrangement by the creditors. These acceptances may be obtained by the corporation before or after the filing of a petition under Chapter XI.

If the arrangement is not accepted at the first meeting by all the creditors affected, it may be confirmed after acceptance in writing by a majority in number of all creditors, representing a majority in amount, or, if the creditors are divided into classes, by a majority in number and amount of all creditors of each class affected by the arrangement. After acceptance of the arrangement, the court appoints the receiver or trustee, or some other person, to receive and distribute, subject to the control of the court, the moneys and consideration, if any, to be deposited by the corporation. It also fixes a time within which the corporation must deposit the consideration to be distributed to the creditors, as well as the money necessary to pay all debts that have priority, and all costs and expenses incurred in connection with the proceedings.

The court is given certain powers through the exercise of which relief is afforded to the corporation. For example, it may permit the rejection of executory contracts; authorize the receivers or trustees, or the corporation, if it is in possession of the property, to lease or sell any property of the corporation upon terms approved by the court; enjoin or stay the commencement or continuation of suits, including suits to enforce liens where notice has been given and cause shown; and do other enumerated acts.

Upon confirmation of the arrangement, the debtor is discharged from all unsecured debts provided for by the arrangement, except undischargeable debts. These include taxes and wages earned by employees within three months from the commencement of the proceedings. If an arrangement is not confirmed, the court may dismiss the proceedings and direct that the bankruptcy be proceeded with pursuant to the provisions of the Bankruptcy Act.

The arrangement provisions. An arrangement, within the meaning of Chapter XI, *must* include provisions modifying or altering rights of unsecured creditors generally or of some class of them upon any terms or for any consideration. It *may* include provisions for the following:

1. Treatment of unsecured debts on a parity one with the other, or for the division of such debts into classes and the treatment thereof in different ways or upon different terms.
2. Rejection of any executory contract.
3. Specific undertakings of the debtor during any period of extension provided for by the arrangement, including provisions for payments on account.
4. Termination, under specified conditions, of any period of extension provided by the arrangement.
5. Continuation of the debtor's business with or without supervision or control by a receiver or by a committee of creditors or otherwise.
6. Payment of debts incurred after the filing of the petition and during the pendency of the arrangement, in priority over the debts affected by such arrangement.
7. Retention of jurisdiction by the court until provisions of the arrangement, after its confirmation, have been performed.
8. Any other appropriate provisions not inconsistent with Chapter XI.

Differences between Chapters X and XI. The fundamental differences between a Chapter X proceeding and a proceeding under Chapter XI may be outlined as follows:

1. A Chapter XI proceeding must always be initiated by the debtor.
2. A majority rather than two-thirds of all creditors is necessary to bind any class of creditors under a Chapter XI proceeding.
3. A Chapter XI proceeding does not affect secured creditors or stockholders.
4. The judge may or may not refer a Chapter XI proceeding to a receiver.

Railroad reorganizations under Section 77. Section 77 of the Bankruptcy Act applies exclusively to railroad reorganizations. It preceded Section 77B by almost two years and Chapter X by four years. Inasmuch as it differs from the industrial reorganization procedure, it might be worth while to point out the essential differences. Under Section 77 the petition to the court may be made voluntarily by the financially embarrassed railroad with the approval of the Interstate Commerce Commission, or by creditors representing 5 per cent or more of the total indebtedness. In practice, however, petitions are usually voluntary. If the court approves the petition, the debtor must give written notice to the stockholders, creditors, and other interested persons. Hearings are held on the choice of trustees, and, if no objections are voiced, the court appoints a trustee with the approval of the I.C.C. The debtor remains in control of the property until the trustees are confirmed. The court, however, must appoint one or more additional trustees if the first appointee was employed by the debtor in the preceding year. Further control is vested in the court in that legal counsel for the trustees may be removed by the judge. The influence of insiders, as a result, is largely nullified by the above provisions; missing, however, is the requirement of disinterestedness in the trustee provided for in Chapter X reorganizations. The trustees in railroad reorganizations assume the posture of operating managers of the debtor rather than the mere instruments of reorganization.

The plan of reorganization under Section 77. The plan of reorganization may be presented by the trustee or the debtor corporation, or by the holders of 10 per cent of a class of securities. These plans are presented to the Interstate Commerce Commission, however, and not to the court, as in the case of an industrial reorganization. The Commission holds hearings on such plans, and at the termination of the hearings, it files a report. In this report the Commission may accept one of the plans already submitted to it or it may propose one of its own. Hearings are held by the Commission on its plan, and a further report—which may or may not be the final report—is submitted to the court. If the court should reject the plan, the matter is referred back to the Commission and the entire procedure is commenced anew.

After the court approves the plan, a copy is forwarded to the Inter-

state Commerce Commission, which in turn notifies all participating parties. The parties thus informed must express their rejection or acceptance of the proposed plan. The results of the voting are transmitted to the court for confirmation. For the plan to be binding, it must have the approval of two-thirds of each class of creditors and, if the company is deemed solvent, the approval of a majority of each class of stockholders recognized. If it is insolvent, the stockholders have no vote. Unlike a reorganization pursuant to Chapter X, the court may find the plan acceptable even if one or more less important classes fail to give the required approval. When the plan has been accepted and the court has confirmed it, the plan is executed under the supervision of the Interstate Commerce Commission.

Differences between Section 77 and Chapter X. Although the differences between the two acts are not entirely defensible, the essential difference rests on the amount of regulation exerted over railroads versus industrials. Such regulation is not an entirely valid basis for the differences between the acts, for public utilities have more in common with railroads in the matter of regulation than with industrials. Recognition of the peculiarities in each type of business, nevertheless, may have merit when we set out to reorganize them. The fact that industrials and public utilities are reorganized under Chapter X and railroads under Section 77 may be due, however, to the growth of industrials and utilities and the apparent decline of railroads. Other possible reasons include the less complex debt structures of utilities as compared with those of railroads, and the effects wrought by the Public Utility Holding Company Act of 1935.

There are three basic differences between a railroad reorganization under Section 77 and an industrial reorganization under the provision of Chapter X. First, the obligation of leading a railroad reorganization through to its consummation rests on the Interstate Commerce Commission, and not, as in Chapter X, on the trustee. The primary function of the trustee in the railroad reorganization is to operate the road. Under Chapter X the trustee is not only the operating official, but he has the additional and important task of preparing the plan of reorganization, conducting the voting, and executing the plan after the court has confirmed it. Second, unlike Chapter X, it is necessary under Section 77 to make a study of the earning power of each division of the railroad as well as of the system as a whole. This analysis forms the basis of the plan of reorganization. Third, a railroad reorganization plan must meet the tests of fairness and feasibility and, in addition, must be in the public interest.

The Mahaffie Act. A great deal of criticism arose against the expensive and slow reorganizations under Section 77 of the Bankruptcy

Act. To remedy this situation, Congress enacted the Mahaffie Act.[18] In essence, this law provides a means of recapitalization or readjustment of the funded debt. Basically, the Act adds a new section, Section 20b, to the Interstate Commerce Act. It provides that a carrier, with the approval of the Commission, may alter or modify any provision of any mortgage, indenture, deed of trust, charter, or other instrument pursuant to which any class of securities has been issued. Before a proposed alteration or modification may be submitted to the security holders involved for their approval, the Commission must hold a public hearing and make a finding that the proposed alteration or modification (1) is within the scope of the law, (2) will be in the public interest, (3) will be in the best interests of the carrier and each class of security holder involved, and (4) will not be adverse to the interests of any creditor of the carrier not affected by such modification or alteration. After the Commission makes such finding, the plan is submitted to a vote of those affected. If less than seventy-five per cent of the aggregate principal amount outstanding of each class of obligations affected votes in favor of the plan, the Commission may not enter an order approving the proposed change. Any person adversely affected by an order of the Commission has the same opportunity for judicial review that he would have in the case of any other order of the Commission.

It is interesting to note that this proceeding is different from bankruptcy in that unsecured creditors cannot instigate the proceeding or derive any benefit from it. It is different from voluntary recapitalization or readjustment in that it is a quasi-judicial proceeding. Such legislation as this bears watching. The results may be heartening, however, and may prove to be the solution to many of the problems in railroad reorganization. The procedure is, in essence, a composition agreement on a grand scale. The future will prove the efficacy of its enactment.

Voluntary and involuntary bankruptcy liquidation. In the preceding discussion our attention was directed at the rehabilitation of the corporation. Such procedure, it was hoped, would preserve the going value of a firm while at the same time protecting the parties involved. Often, however, it is obvious that a company in financial difficulty cannot be rehabilitated. The demand for the product may have ceased, the plant and equipment may be obsolete, or the creditors may have lost faith in the company and its management. Sometimes reorganization is attempted and only then does it become apparent that the venture could not be made profitable. In either case, dissolution becomes

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[18] 62 Stat. 162 (1948), 49 U.S.C. § 20b.

necessary. If the company is adjudged legally insolvent, the liquidation may be effected through bankruptcy proceedings.[19]

When a business reaches insolvency, the assets become fair game for the creditors. The rush of the creditors to acquire judgments against the insolvent firm generally results in unequal treatment for all concerned. The possibility of a concealment of property by the debtor is apparent, and disorganized sale brings little recovery. The orderly liquidation of the debtor's assets under bankruptcy proceedings obviates this result. Concealment of assets is prevented, for the most part, under penalty of criminal action by the court.

Ordinary bankruptcy proceedings may be initiated by the insolvent debtor or by its creditors. All persons and corporations except railroad, moneyed (insurance and banking), and municipal corporations may go into bankruptcy voluntarily. Involuntary proceedings may not be entered against railroad, moneyed, or municipal corporations, or against wage earners or farmers. In the case of voluntary proceedings, the petition to be declared a bankrupt is filed, and the adjudication usually follows as a matter of course; from then on the proceedings are the same as in involuntary bankruptcy.[20]

Ordinary bankruptcy procedure. In cases of involuntary bankruptcy, the petition is filed by three creditors having claims aggregating $500 or more in excess of the value of securities held by them, or, where there are less than twelve creditors, by one creditor with a claim of at least $500. It must be shown that the debtor owes in the aggregate at least $1,000, that he is totally insolvent,[21] and that a so-called act of bankruptcy was committed within four months of the filing of the petition. These acts of bankruptcy may be enumerated as follows:

1. Transferring or concealing property with intent to defraud creditors.
2. Giving preferences to certain creditors.
3. Permitting creditors to obtain through legal proceedings any levy, attachment, judgment, or other lien, and not vacating or discharging the same within thirty days.
4. Making an assignment for the benefit of creditors.
5. Permitting, or suffering voluntarily or involuntarily, the appointment of a receiver or trustee while insolvent or unable to pay debts.

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[19] See Bankruptcy Act, Sec. 67.

[20] Instead of going into voluntary bankruptcy, concerns usually get some friendly creditors to bring the action. Two reasons account for this: in the first place, the debtor gives the appearance of working harmoniously with his creditors; and in the second place, a voluntary bankruptcy precludes a discharge in a future bankruptcy unless at least six years have intervened.

[21] Insolvency under the statute means that total assets, at a fair valuation, are insufficient to pay the debts of the bankrupt.

6. Making a statement in writing admitting insolvency and declaring willingness to be adjudged a bankrupt.

It is not always necessary, under the statute, that the involuntary bankrupt should have been insolvent at the time the act of bankruptcy was committed or at the time the petition was filed. For example, it is not necessary that the alleged bankrupt should have been insolvent at the time he conveyed or removed property with intent to defraud his creditors. Under the second, third, and fifth acts noted above, however, insolvency at the time of the commission of the act of bankruptcy is essential.

Usually, as soon as the petition is filed, a receiver in bankruptcy is appointed by the bankruptcy court [22] to take the property and to hold it until the trustee in bankruptcy is selected. The latter is an officer elected by the creditors at their first meeting, to hold and, where necessary, to recover, the property, to turn it into cash, and to distribute the proceeds according to law. After the proceedings are initiated, the court turns over further control of the administration to a referee in bankruptcy—a minor officer with certain judicial powers. He may issue practically all orders necessary to promote the settlement of the bankrupt estate, although he may not discharge the bankrupt. The assets are sold and the proceeds distributed according to law. Since the assets of the bankrupt are usually insufficient to pay all the creditors, the order of priority becomes crucial. The statute provides the order of priority as follows:

1. The necessary expenses of preserving and administering the bankrupt estate.
2. Wages due workers if earned within three months prior to filing of petition—not to exceed $600 per person.
3. Taxes due the United States, state, county, or subdivision thereof.
4. Secured creditors, with proceeds of sale of specific property so pledged or mortgaged.
5. Rent obligations accrued three months prior to filing of petition.
6. General, or unsecured, creditors—trade and bank creditors, debenture bonds, and any remaining unpaid balances to secured creditors after sale of specific property.

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[22] The Federal district courts are given exclusive jurisdiction over discharges in bankruptcy, although the proper bankruptcy official may bring and defend collateral actions, such as an action to recover property, in the state courts. Receivership proceedings are still used to wind up the affairs of an insolvent debtor in state courts. The appointment, however, is an act of bankruptcy. If within four months of such appointment, creditors file a petition of involuntary bankruptcy against the debtor, the federal court will receive exclusive jurisdiction. Discharge of debts, however, can only be accomplished under the jurisdiction of a federal court or by agreement among the parties.

If the bankrupt has not been guilty of fraud, he is discharged from all liability except for certain classes of debts that, with the exception of taxes, are so unusual that they need not be mentioned here. Corporations as well as individuals may be discharged in bankruptcy.[23]

Dissolution proceedings. Sometimes solvent corporations are dissolved, either because the business is shown to be unprofitable and to be leading toward insolvency, or because the owners wish to retire, or because taxes are burdensome, or becaues some other reason makes the continuation of the business under the corporate form inexpedient. In all such cases, the dissolution follows the method prescribed by the appropriate statute of the state where the company was organized. Usually pursuant to a vote of the stockholders, the directors wind up the company, pay the debts, and distribute the remainder of the assets among the stockholders. Some formal final step may be required, such as publication of notice of dissolution in a newspaper and filing of appropriate records in the public office in which the certificate of incorporation was originally filed.

Distribution upon dissolution. The statute under which the dissolution is effected may indicate the order in which claims must be paid. If no order or preference is prescribed, the general rules of distribution are followed. These require that debts which are secured by liens must be satisfied out of the security, before the claims of unsecured creditors are paid. After payment of secured and unsecured creditors, what remains is divided ratably among the stockholders in proportion to the number of shares held by each. Preferred and common stock share alike, unless some preference in distribution is given to one class of stockholders. The preferences are found usually in the articles of incorporation or in the contract under which the shares are held. Thus, a certificate of incorporation may provide that "upon dissolution, the preferred shall be paid in full at par before any amount shall be paid on account of the common shares." This gives the preferred stock a preference as to assets, but raises this question: have the preferred stockholders a right to share in any surplus beyond the amount required to pay all capital contributions? The courts in this country seem inclined to view the provision that, on dissolution, the preferred shareholders be paid in full before the common as impliedly taking away from the preferred stockholders the right to participate in the excess assets. After payment of the preferred, the residual net worth would go to the common stockholders. Sometimes a provision is found in the articles of incorporation to the effect that the cumula-

[23] If one or more, but not all, of the general partners of a partnership are adjudicated bankrupt, the partnership property is not administered in bankruptcy except upon consent of the general partner or partners not adjudicated bankrupt; but the general partner or partners not adjudicated bankrupt must deliver the partnership business as expeditiously as possible and account for the interest of the general partner or partners adjudged bankrupt.

tive preferred stock shall be entitled to be paid in full the par value of their stock and all unpaid dividends accrued thereon, before any distribution shall be made on the common stock. Such a provision entitles the holders of preferred stock to the par value of their shares plus any dividends which have actually been earned and are unpaid, before anything can be paid to the common shareholders.

Disadvantages of bankruptcy. The bankruptcy device has been used by some persons for illegal purposes. Some unprincipled people have used the act to evade paying their just obligations. Ingenious devices have been used to conceal assets in spite of the penalties imposed for such actions.[24] The expenses of a proceeding under the Act are high. In many of the cases such costs consume most of the bankrupt's assets. As a result, little is left for distribution to the creditors. The forced liquidation of the assets, orderly as it may be, is another factor in the paucity of funds available for distribution to the claimants. The procedure in appointing trustees, referees, and receivers is not so disinterested as it might be. In many cases lawyers are chosen for the work, and there is no assurance that such persons will possess the necessary business acumen to do the job efficiently. The discharge in bankruptcy, however, does make it possible for persons to return to the business world with the knowledge that their new endeavor will not be subject to eternal threats of seizure by old creditors. To this end an orderly bankruptcy law is a necessary element in the business and economic legislation of an enlightened free enterprise system.

Problem

The Loseit Corporation operated profitably during the war and post-war years. But in the last five years, because of poor management, the company has been losing money steadily. Although the company is insolvent at the present time, the prospects for a reorganization are promising, and the company should recover within 2 or 3 years. The balance sheet at present is as follows:

BALANCE SHEET

(prior to reorganization)

Cash	$ 12,000	Notes payable	$200,000
Notes receivable	168,000	Accounts payable	180,000
Accounts receivable	130,000	Accrued wages	20,000
Investments	72,000		
		Total current liabilities	$400,000
Total current assets	$382,000	First mortgage bonds	40,000
Fixed assets	220,000	6% preferred stock ($100 par)	200,000
Deficit	118,000	Common stock ($100 par)	80,000
Total	$720,000	*Total*	$720,000

[24] The penalties imposed on persons who wilfully conceal assets is rather severe. The act provides for imprisonment in a Federal penitentiary for a period of not more than 5 years, a fine of not more than $5,000, or both.

(a) Prepare a statement of the new capitalization and a balance sheet giving effect to the reorganization where the following have been agreed upon:

(1) First mortgage bondholders have agreed to take 50 per cent of their holdings in 4 per cent income bonds and 50 per cent in new $5 par common stock.

(2) Notes payable (bank loans) to be reduced 20 per cent and will take the form of 62½ per cent in 6 per cent preferred stock ($10 par) and 37½ per cent in notes payable (5 per cent interest).

(3) Accounts payable reduced 40 per cent, the remainder to consist of 55½ per cent in the 6 per cent preferred stock ($10 par) and 44½ per cent to be carried as accounts payable.

(4) Present preferred stock to be exchanged for new $5 par common.

(5) Common stockholders to subscribe to one share of new $5 par common for each two old shares held.

(6) Unused plant and equipment carried on the books at $30,000 to be sold for $20,000 cash.

(b) If the earnings are expected to reach $20,000 after expenses but excluding interest and dividends, is the plan of reorganization practical? Explain your answer.

CHAPTER 28

Public Policy

*by Professor Milton S. Goldberg**

Introduction. We have made a thorough study of the problems confronting the businessman when he undertakes the organization and management of a corporation. We have presented the modern methods of organizing a corporation, of financing its permanent and working capital needs, and of managing its income and surplus. We have discussed the methods of expanding the business and of recapitalizing or reorganizing it, as conditions require. But there is another area in which the problems confronting a corporation and its management are less well-defined and still unresolved—the area of public policy. Is the corporation accountable to the public? What should be the Government's attitude toward the corporate form of business? How is our economy affected by Government intervention and regulation of business? In this chapter we shall present these problems and some of the factors that affect their solution in the best interest of the public. First, let us see why public policy has become such an important element in the fields of financial organization and management of business.

The conduct of business is now more than ever in the hands of the corporation. The savings of a great part of the public have been exchanged for corporate securities: directly through stock purchases, and indirectly through insurance companies, investment companies, and other financial institutions. The corporation, therefore, has become the predominant form of business enterprise and, as such, requires more than casual attention from our Government. The environment in which it now functions is quite different from the one

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prevalent at the turn of the century. The analysis of long-term social movements is not easily made, nor is it quickly evaluated. As the corporation assumes an even greater force in our economy, principles and policies of social justice compel society to maintain some form of control to protect its interests.

Such difficult problems as stockholder representation, the need for venture capital, stabilization, preservation of competition, the use of debt, taxation, and the regulation of public utilities are but a few of the problems that face us as we seek a more abundant economy. Much that has occurred since the beginning of this century points to increasing interest in public policy in this country. The creation of the Federal Reserve System was designed to make our monetary system more flexible and sensitive to the changing needs of our economy: the passage of the Federal Trade Commission Act and the Clayton Act (see page 451) in 1914 sought to prevent and punish certain monopolistic practices of business: the depression of the 1930's saw us seek Government assistance to alleviate the horrors of massive unemployment and idle resources. These are but a few examples of the trend toward a concept of public interest and general welfare.

Many writers have given prominence to the effect of the depression of the 1930's on the amount and type of Government regulation in our economy. No society, however, can exist without a modicum of directional force. The market place, under capitalism, usually performed this function in the past. Many deep-seated changes have made the market place much different from the simple one contemplated by Adam Smith. When we fully recognize these profound changes, we understand the increased interest in some form of protection through other means. Policies that prevailed before the 1930's may be as obsolete today as the products of that time. We need only look at the Federal monetary, fiscal, and labor legislation to see the changes in the environment.

Since we are aware of the altered character of the market place and the dominant forces contained within the economy, we must evaluate them and seek a sophisticated approach to the resulting problems. The objectives of maximum production and efficient distribution within the limits of our resources are still our primary concern. The ever-present query is: Who will be charged with the task of accomplishing the job of preserving the maximum of social benefits?

Two factors have led to increased Government intervention in our economic life: the depression of the 1930's and World War II. We now face the enigma of how much Government intervention we can retain and still preserve individual liberty and initiative. To return to the "good old days" would probably be impossible and would

surely lead to some type of economic chaos. The present immense debt of the Government will make high taxes necessary for many years to come. The unsettled political situation in the world will continue to call for tremendous yearly defense appropriations. These factors and many others foretell the huge impact that our Government will continue to have on the entire economy. The extent to which businessmen and their corporations understand and provide for such constant relationships will determine, in a large measure, the amount of Government control for many years hence.

Corporate accountability. A detached attitude bordering on isolation has characterized the corporation in this country. The classical concept was that to follow one's self-interest would automatically bring about the greatest good for all. The idea became so much a part of our thinking that it was not questioned until recent times. This attitude is essentially still that of the large corporation, which many writers claim to be a unique institution, totally different from its smaller predecessors.[1]

Legally, the corporation is a creature of the law created by the state, and as such it may have an obligation to the public as well as to the owners of the enterprise. Initially, the corporation acquired its charter from the legislature, but only after proof that a public purpose would be served by its creation. The expansion of business in the period that followed led to rather liberal treatment of the corporate form. In the past three or four decades, corporate business has experienced such growth that we may now find sufficient cause to take a less liberal attitude.

The public interest is emphasized by the present separation of ownership from control. The stockholders generally elect the directors, but the effective use of such power is not easily accomplished nor resolutely exercised. The management of many dollars of corporate assets is carried on by a few "professional managers" who own a very small percentage of the outstanding stock. Such a situation might be characterized as one that should involve a broad concept of trusteeship closely akin to public welfare.[2] Stockholder apathy has become almost universal, with the abandonment of many rights formerly exercised by the security holders.[3] The intervention of the Government, for the most part, has created no new rights but merely altered the group exercising them. The management of many huge corporations

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[1] A full explanation of this concept may be found in A. A Berle, Jr., and G. C. Means, *The Modern Corporation and Private Property* (New York: The Macmillan Co.).

[2] See generally, Garrett, "Attitudes on Corporate Democracy—A Critical Analysis," 51 Northwestern University L. Rev. 310, (1956).

[3] But see page 51 for discussion of recent trends in stockholder attitude.

has been compared to a feudal estate with the succession to boards of directors totally within the power of the incumbents.

The increased emphasis on the public interest has been the impelling force behind the Government's intrusion into the private domain. The only manner in which the virility and virtue of private interest can be preserved is with full recognition of the altered character of the environment. We may now turn our attention to a consideration of several problems in somewhat greater detail.

Ownership and management. One of the major problems resulting from the growth of the large corporation is the separation of ownership from management. This problem is discussed fully in Chapter 4, "Corporate Management and Control." There is no need to repeat the discussion here, but the reader should review the discussion and consider it in the light of its relation to the public interest.

Financial regulation. Unfortunately, there is little agreement on an acceptable philosophy of business regulatory policy. Moreover, there is faint hope of there ever existing uniformity among the various states in regard to this problem. The Uniform Stock Transfer Act has been adopted in all the states but has little significance to, or impact upon, corporate financial policy. The Model Business Corporation Act has been adopted in only five states and the prospects of its further adoption seem remote. The areas of most importance, where uniformity is especially desirable, for example, the sale and issue of securities, taxation, reorganization, capitalization, management responsibility, and promotion, remain almost untouched. We have at present two entirely different views on financial regulation. One view contends that the financial affairs of the corporation should be regulated; the other proposes to follow a policy of hands-off, with concentration on educating the workers, investors, and consumers. The fear of large-scale enterprise is still present in many people's thinking. This emotional attitude discourages financial growth, in whatever fashion it occurs, in spite of the advantages derived thereby. When the element of fear is mixed with large size, the outcome is a hodgepodge of regulatory acts with little agreement on the fundamental objectives. (See the discussion of regulatory policy on pages 580 *et seq.*)

Corporate fiscal policy. Little public control has been exercised over the general fiscal policies of corporations, except in those classified as "businesses affected with a public interest." This distinction has been characterized by many writers as artificial and illogical. Such accusations may contain an element of truth, but they leave us in a dilemma when we face the fact that many of these businesses are given exclusive areas in which to sell their "product."

Most state corporation laws prohibit the payment of dividends ex-

cept out of earnings, limit the creation of debt beyond a stated percentage of the value of the corporate property, and forbid the issuance of certain types of securities. Every state has enacted a general incorporation law, the various laws differing only in detail. Their real difference lies in their provisions for taxation.

Suggestions have been made from time to time, and bills have been introduced in Congress, providing for Federal incorporation or Federal licensing of corporations. Although such a law would reach only those enterprises engaged in or affecting interstate commerce, it would appear that, with the liberal interpretation of the interstate commerce clause arising from several recent decisions, most business corporations would be affected. A plan of Federal licensing of corporations might prove more feasible with a proviso that such enterprises be barred from engaging in interstate commerce if they refused to acquire such a license. This measure would avoid conflicts with state incorporation laws and tax levies and effect much needed uniformity in financial practices.

The great force behind economic activity in the recent past was the maximization of profits. The rather narrow concept of business goals resulted in the tremendous output of our economic system, but, at times, such an attitude brought forth unfair and even predatory practices. We can no longer adhere to such a short-sighted principle. The modern corporation has become a potent force in our social and economic environment and, as such, can no longer be taken lightly. Formerly, the owners of the enterprise were the only persons involved. Decisions concerning operations were made with them in mind. Today, two additional groups of individuals must be recognized and heard: employees and the public. The growth of labor-union membership has made this group a potent force in modern corporate management. The bargaining table has become a forum where owners and employees discuss and decide much that formerly was decided unilaterally. The public is generally heard through its elected representatives in the state legislatures and the Congress of the United States. Regulatory acts of various kinds affecting the business community are passed by these legislative bodies, with taxation a part of the entire program.

Taxation and investment. The student of finance will find that the effect of taxation on private investment decisions is significant. Present levels of taxation have an impact upon business policy that cannot be ignored. The role of government in our economic life has expanded, with the burden of taxation increasing concomitantly. The functions of government are no longer limited to mere maintenance of law and order; they encompass the huge areas of public education, roads, mental health, unemployment insurance, economic stability, and so-

cial security. The search for more revenue to support the additional services prompted the interest in taxation of corporations. Corporations do not vote and are fewer in number than individuals—two excellent reasons why they have received such attention.

Much has been written on the subject of taxes since biblical times. Today, discussions are generally pointed in the direction of the effects upon business incentive and methods of financing enterprises. We cannot expect the taxation of business to have no effect upon the decision-making process.[4] Our efforts are aimed at striking a balance, with a minimum effect upon business initiative and activity. Tax policies may be designed, however, to curb entirely various undesirable activities. They may reach the point of stopping altogether any activity found inimical to the economy. The use of taxation for this purpose can be most effective. The use of the taxing power as an instrument of public policy is most often only a part of the entire program of business-government relationships. We have not yet agreed unanimously on just what type of tax system is most desirable nor reached an agreeable set of objectives or standards of measurement for our tax program. Other more direct methods of regulation are in use and, in fact, make up the bulk of the program.

The taxing of corporations involves many controversial problems but also has several important objectives.[5] The obvious one, revenue, need not be discussed here. The other objectives are the elimination of "excess" profits, encouragement of the use of equity funds, and purposeful expansion. No one tax will accomplish all of these objectives. It is increasingly difficult to find tax authorities in agreement on the true impact and effect of particular levies. The aforementioned goals, however, do serve as benchmarks in deciding on the tax-mix and aid immensely in the administration and direction of tax policy. Each of these goals is discussed in detail in this chapter.

State tax programs. The tax programs of the various states differ widely. Many states are reluctant to tax heavily for fear of discouraging the location of new plant facilities in the state. In many cases tax programs are designed to attract industry, not to tax it. Several authors have made investigations into this subject and found the state tax structure to have had little impact on plant-location decisions. Source of raw materials, labor supply, transportation facilities, and markets—foreign and domestic—seem to be more important considerations than state tax programs. The Federal tax program lends itself to a uniform, nationwide policy applicable to all business. Thus, we

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[4] See J. Keith Butters, *Effects of Taxation on Inventory Accounting and Policies*, Boston: Harvard Graduate School of Business Administration, 1949.

[5] Dan Throop Smith, *Effects of Taxation: Corporate Financial Policy*, Boston: Harvard Graduate School of Business Administration, 1952.

should be concerned with the Federal tax structure and its impact rather than with the various state programs.

Taxation of excess profits. In our earlier discussion of the capitalistic system, we noted that profits performed the vital function of encouraging production. If profits were large relative to the risks involved, new ventures would be launched. As the number of new enterprises, and therefore capacity, increased, lower prices would result. We are aware, however, that the entry and exit of businesses in our economy do not occur automatically. Many imperfections exist in our economy, with excess profits persisting in many industries. Traditionally, we associate large-scale enterprise with these so-called monopoly profits. This association is not necessarily correct, for such profits exist in small enterprises as well. Our antitrust program has been aimed at the large corporations, and, as a result, we are more aware of their existence. In fact, the Federal antitrust program is not equipped to deal with monopoly profits when the enterprises are small and spread over great areas. A tax program might be designed to reach these profits where other means are inept and inadequate.

Legislation affecting excess profits has usually been passed in times of stress and emergency. During wartime, large profits may be earned as a direct result of the abnormal conditions in the market place. Whether they are excessive and temporary is a difficult question to answer. If they exist in "normal" years, we may characterize them as excess and tax them away. Some writers have concluded that such profits provide the funds necessary for research and development of new and improved products—that without them, much of our economy's growth would be dampened. What measure of excessiveness shall we use? Shall we determine a base figure on some so-called normal period in our economic history, or use some other method to arrive at a solution?

In most cases we have arbitrarily determined a rate of return that is to be considered normal. Any earnings over this figure have been declared excessive. The problem of setting the rate of return is, however, only half the dilemma. The additional problem presented by such a levy is: Upon what asset value shall we impose the limited rate of return? In 1917 Congress passed an excess profits tax which defined a normal rate of return as 8 per cent on invested capital. The tax was levied as an additional tax over and above the regular income tax. The regular income tax was allowed as a credit prior to computing the excess profits tax. At this time a war profits tax was also in existence, and the enterprise was required to pay under the one requiring the higher amount. Although these taxes produced large revenues, neither proved popular and they were repealed shortly after World War I ended.

In 1940 an excess profits tax was enacted by Congress with a different method of computation. The corporation was permitted to figure its tax by two methods and was privileged to choose the one bearing the lowest amount of liability. The problem of ascertaining what amount of capital was invested in the business again presented itself. Under this act, invested capital included the paid-in amounts plus all earnings retained in the business. Undoubtedly many corporations, as a result, retained earnings in the enterprise that might have been distributed as dividends. An excess profits tax provision was enacted in 1950, with many arguments put forward in its behalf and in opposition. Some of the objections were that it caused indifference to increasing costs, discouraged incentive, hampered expansion, injured new and growing businesses, and was too difficult to administer. Profits would be limited with loss of incentives, dividends would be reduced, and profits ordinarily retained in the business would be taxed away. A permanent excess profits tax does not seem probable so long as the corporate income tax remains at the present level. An excess profits tax might well be used to reduce the advantages of monopoly, and the corporate income tax may be the means to reduce the size of enterprise. A progressive corporate income tax would accomplish the latter objective with great efficacy. We are, however, dealing with two different problems: (1) the size of the enterprise, and (2) the amount of profits accruing to a monopolist. Public-policy considerations require us to handle these two distinctly different factors separately.

Among the many criteria of a "good" tax, the "ability to pay" principle is foremost in most people's minds. An income tax of a progressive nature has been held out as a prime example of compliance. If a progressive income tax were placed upon corporate income, those persons holding stock in large corporations would be taxed at higher rates than those of smaller corporations. Such a result would seem to be inequitable. For this reason, corporations have never been taxed under a progressive set of rates. The issue is not dead, however, and proposals are introduced from time to time to levy a progressive corporate income tax. The use of tax laws to limit size is doomed generally to failure. Many corporations already have broken down their operations into several separate corporations in order to soften the effect of the one surtax now levied.

The question yet to be answered is, "How big is too big?" Many industries require large amounts of capital to begin operations. Large size may be the result of planned and normal expansion. Undoubtedly, some enterprises have grown beyond the size where "bigness" results in proportionate economies. This result may not be desirable, but that taxation is the best method of correcting it is doubtful. More effective

than an indirect tax program may be control through legislation that prevents restraint of trade, price fixing, market allocation, and unfair methods of competition.

Equity versus borrowed funds. Much has been written on the subject of taxation and its effect on the financial structure of the corporate form of organization. The discussions reach much further—at times even into the influences on sources of funds for financing enterprise. The present corporate income tax is levied on the net income available to ownership interests. The interest paid to the lender of capital funds is a deductible item—a business expense—and is subtracted before the income tax is computed. The net result may be an increase in the use of borrowed funds in corporate capital structures. Variations in the type of securities issued have become almost limitless. The desire to create a security that has the characteristics of a stock yet legally is a bond has led to the hybridization of security forms. The use of borrowed funds injects rigidities into the conduct of an enterprise; the fixed charges must be met or creditors take over. We noted in the chapters on failure and reorganization that such fixed charges can be disastrous to a firm with a contracting income. A business with borrowed funds must meet its interest payments or face receivership in one form or another. The early corporate income tax law did not permit the deduction of interest charges beyond a certain point. This limitation did not last long, and in 1918 all interest on borrowed funds became fully deductible.

It has been urged that the corporate income tax be levied on net income before the deduction of any interest or dividends. This, unfortunately, would do violence to the legal concepts which differentiate these two types of payments. The interest on a bond or note must be paid—a binding legal promise was made to do so. The declaration of a dividend is discretionary. A tax on income before interest or dividends would erase the advantages accruing to the use of borrowed funds and thereby discourage their adoption. Interest on such funds has long been considered a cost, and is considered such in our courts today. This problem has vexed the fiscal authorities for many years, and a satisfactory solution is yet to be found.

The problem of taxing the income of a corporation "twice" is even more perplexing. The so-called "double" taxation is the system of taxing the net income of a corporation and again taxing the security holder when he receives the dividend. Yet this practice is not entirely a case of double taxation because two transfers are involved. The corporation may pay the maximum rate on its net income while the residue paid to the stockholder is taxed according to the personal income tax rate of the recipient. We might eliminate the corporate income tax altogether—a highly improbable event. A tax credit might

be given those receiving dividends from corporations who have already paid a tax on such income. To a limited extent, this has already been done under the Revenue Act of 1954. The avowed purpose of the dividend credit was to eliminate partially the double taxation of corporate income. The additional effects of encouraging the use of equity forms of financing and the investment in equity securities should not go unmentioned.

Purposeful expansion. The fiscal authorities of the Federal Government have upon occasion encouraged and supported certain business practices. This was done with subsidies, direct and indirect. During World War II, many direct loans were made to enterprises to provide expansion of facilities for the production of armaments and supplies. The Small Business Administration is presently lending money to small businesses in defense work and also is lending public funds to companies unable to acquire money through present private sources. The S.B.A. not only makes direct loans but supplies funds to small investment companies, which, in turn, make loans to small business enterprises. (See pages 427–428.)

The accelerated amortization program for companies providing defense materials is surely another important device to promote expansion. This privilege brought about an increase in investment by permitting the write-off within the emergency period of any equipment or buildings acquired for national defense. The Second Revenue Act of 1940 permitted the War Production Board to certify the necessity for such stepped-up amortization. As a result, over 7 billion dollars in facilities were acquired with permission to write them off at the fast rate. In 1950 the five-year privilege was re-enacted, with the limitation that only 60 per cent to 75 per cent of the cost of assets acquired could be amortized in the five-year period, the balance to be depreciated at normal rates.

The use of this device, unfortunately, has its shortcomings and inequities. Certain businesses were encouraged to expand while others were not. Those involved in defense work were encouraged to increase their capacity while other segments of the economy were held static. In fact, certain businesses may have expanded their facilities beyond foreseeable peacetime needs. The privilege, in addition, may have aggravated inequities in the tax burden among corporations and may have resulted in higher tax levies when the full depreciation was used up. There is little doubt, however, that much capital spending was the direct result of this privilege. Whether the accelerated expansion of fixed assets was a healthy result is yet to be assessed. (See, also, the year-of-acquisition depreciation allowed by the 1958 tax law, discussed at page 359.)

Funds for investment. The sources of funds for corporate financing are (1) retained income and (2) the savings of individuals, either direct or through institutional investors. Through the sale of securities the latter is tapped; the former is a matter of income, reserve, and dividend policy. The high corporate tax rates have had a profound effect on both sources. The tax rate presently in force deducts a large part of the corporate income before the amount available for dividends is ascertained. Out of this balance, dividends may be disbursed; the amount left is retained earnings. This figure may be far short of the amounts necessary to expand the business and maintain a healthy financial picture.

Compounding the problem is the fact that a great part of the funds for investment in the United States comes from persons with incomes of $10,000 or more, and these persons are taxed quite heavily. It is not difficult to appreciate the problem of how the sources of funds for investment have been severely limited. Only the ability to take the funds out of a business in the form of capital gains makes the investor willing to purchase corporate securities. If an individual received a dividend and was taxed at 90 per cent, he would be less eager to invest than if his dividend receipts were taxed at 22 per cent. Those with the funds to invest are generally in the higher surtax brackets—one may wonder why they would ever invest in private corporate equities at any time. The tax-exempt securities, therefore, become a desirable place for many in the upper-income groups to put their funds.

The effect of the income tax on the incentive to work, save, or invest has been discussed in numerous articles and monographs. Many problems defy solution in this area, with little empirical data available for proof. Most writers agree that a tax upon income, personal or corporate, will have an effect on incentive. The problems are the effect, the degree of intensity, and the direction. Conceivably, a tax on income might have a salutary effect upon incentive, at least within given areas.

Competition and economic security. Stabilization of business and economic security are foremost in the minds of many people. Although the business cycle has been the subject of much discussion, it was assumed to be an integral part of our economy and, for the most part, was to be tolerated. The Government, in the minds of many, should strive to alleviate the effects of this phenomenon to the limit of its resources. Arguments are numerous on the other side of this question, with a "hands off" policy held to be the most desirable. The Employment Act of 1946 (see page 575) commits the Government to take any measures necessary for a healthy economy. It states

that it is the Government's responsibility to strive for "conditions under which useful employment opportunities will be available to those seeking them." The validity of such a position, however, is still the subject of much debate. Business has been accused of causing the business cycle and held accountable for its share in disposing of this ill. Many of the problems presently facing our economy have been laid at the doorstep of business.

The first duty of corporate management is to the owners and creditors of the enterprise. Their interests are paramount—at least, this seems apparent in the financial and legal writings to date. Dividend policies, wage agreements, and expansion programs are subjects for internal decision-making groups. If the conclusions reached are tempered by welfare concepts, the ultimate outcome of every decision is vitally affected. Many businessmen agree that a stable economy is desirable, since fluctuating earnings and uncertainty do violence to well-laid plans and programs. Can we maintain a growing, expanding business community and yet continue to maintain stability? This perplexing question is yet to be fully answered. Some form of positive control by Government seems to be inevitable. This may not be desirable under a purely competitive economic system, at least in the classical sense. The choice, however, is not between rugged individualism and state socialism. Instead, it is a search for some form of self-government in business or corporate trusteeship with the public an interested party.

Unfortunately, we may become preoccupied with the dangers of the business cycle and lose sight of the need for a flexible and fluid economy. Growth may not be possible without some creaking and groaning in the economy. Many problems arise in this context, especially when the Government's role is no longer merely passive. At what levels do we stabilize? What provisions need be made for growth and changing patterns of behavior? The delicate balance between public and private interests becomes tenuous and, to many individuals, unrealistic. The degree and nature of competition may not be the same in the minds of those involved, with the concept of workable or effective competition becoming the only acceptable answer to the dilemma. Under classical theory, price and output were determined in the market place. Many feel that the vitality and force of competition may be seriously impaired by government action. It may, however, be aided and enhanced by governmental programs to maintain and encourage competitive behavior.

The model competitive system. The misunderstanding and confusion over what comprises the competitive system arise from the fact that it is based on a model rather than a fact. The competitive system is a concept against which we measure the degree of imper-

fection existing in the market place.[6] A free competitive market presupposes a homogeneous product, numerous buyers and sellers, independent action, full knowledge of the market, full mobility of productive factors, and no barriers to entry or exit. No buyer or seller would be permitted to have control of the market. Price would be determined by the free action of supply and demand. Prices would not remain above lowest average total unit cost of production. As a result, entry would occur in those industries which produced those things people wanted, where returns were above cost, and exit would occur in those industries where returns were deficient. Unused capacity would exist for very short periods of time under this system. If capital or labor were unused, its price would fall until a level was reached where it could be employed properly.

The above is an oversimplified explanation of the competitive model. There is a good deal of difference between the model and actuality. The model has never existed anywhere in real life, at least in its totality. It is, nevertheless, a useful device, since it provides a standard to which we may refer and compare existing market conditions. A public policy that fails to recognize the distinctions and differences between the theoretical model and reality is doomed to failure. A program that attempts to achieve a system that never has existed and cannot exist seems an absurd and valueless one.

How the Government has contributed to the decline of competition. To a certain extent, the Government has contributed to the decline of competition. The development of general incorporation laws has made it possible to gather great quantities of capital into one enterprise with great ease. The increasing laxity of the provisions of the laws has encouraged many sharp practices. A favorable form of business enterprise is a convenient vehicle to reach large-scale operations. The patent, trademark, and copyright laws are, in essence, legal monopolies created and protected by government. They may have encouraged the tremendous technological development in this country, but they are in direct opposition to the concept of competition. The power to retain a patent right over a period of years may permit a company to become entrenched to a point where it would be difficult to challenge even after the patent legally expires.

The awarding of production, research, and other types of contracts to large firms in time of emergency or war may have contributed to the growth of concentration. The great expansion of the large firms which availed themselves of the fast tax write-offs gave further

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[6] See John M. Blair, "Technology and Size," *American Economic Review,* XXXVIII, No. 2 (1948), pp. 121–153; J. S. Bain, "Economies of Scale, Concentration, and the Condition of Entry in Twenty Manufacturing Industries," *American Economic Review,* XLIV, 1954.

impetus to a limited number of firms to increase capacity. Government-erected trade barriers have restrained and limited competition—tariffs and milk inspection laws are examples of this behavior. The resale price maintenance laws, the Robinson-Patman Act, Webb Pomerene Act, and the antitrust laws themselves (see Chapter 22) may be held accountable for some of the decline in competitive behavior.

Public policy and economic growth and stability. The Great Depression, which followed the 1929 crash, caused widespread unemployment, a tremendous loss of output, and great human distress. The depressed conditions of the 1930's brought action by national, state, and local governments to combat the situation and bring about a return to prosperity. Yet, these radical actions—radical by predepression standards—were inadequate to alleviate the depressed conditions in the economy. More than ten million persons were still unemployed in 1938, and by 1940 over eight million were still jobless. Many writers held to the proposition that Government activities in this area were doomed to failure from the outset. Others thought that the Government program was merely too small and too late. The latter position may be more correct—at least, this seems true when we look at the effects of Government purchases during World War II. In 1940 Government purchases were in the neighborhood of $30 billion, or about 14 per cent of GNP. In 1944 the Government purchased goods and services amounting to 47 per cent of GNP, or about $150 billion. Unemployment fell to less than one million, while the total work force increased approximately 10 million persons. Many persons inside Government, as well as several outside, were impressed with the Government's power to increase GNP. Many economists and politicians felt that, if this could be accomplished during wartime, why not in peacetime also? The Federal Government had become an important force in the economy, much greater than traditional concepts of the recent past. The pattern has continued to the present time, with the Federal Government alone taxing GNP at varying percentages between 12 and 22 per cent. The unequalled prosperity since World War II, with only minor dips, has apparently indicated that a full employment economy is a possibility, if not a reality. Some questions may be raised regarding the manner in which the continued rise in GNP and personal disposable income has been accomplished. The feeling of some authorities that such would not have been possible without tremendous outlays for defense is not totally without merit. The large size of Government tax and expenditure programs, added to the huge national debt, make it increasingly difficult to keep the National Government from exerting a tremendous effect on the entire economy. Much, however, was learned during the

war period regarding the ability of the Government to fight depressions. This knowledge, coupled with the fear of a depression resembling the one following World War I, resulted in a large measure of agreement on a public policy geared to promoting stability and growth in the entire economy.

The Employment Act of 1946. This act, an outgrowth of the people's desire to give body to the policy of stability, listed three basic elements or objectives of public policy: (1) maximum purchasing power, (2) stable prices, and (3) maximum production. The terms are broad and general, and will be redefined from time to time as new problems and unforeseen situations are faced. It should be noted, however, that full employment was not the only objective of the National Government's economic policy. An economy of inefficient producers and inflationary prices may result in full employment, but the costs would be out of proportion with the results. The standard of living would not rise, and the distribution of wealth would be further disturbed. The harmful effects of deflation, or for that matter inflation, are too well known to bear discussion. A policy of promoting increased productivity and a stable, though rising, price level could result in a rising standard of living for the entire nation. A program with the sole objective of full employment would be an inadequate one, falling far short of this nation's aspirations and potential. The tnree-pronged set of objectives mentioned above is not, of necessity, easy to accomplish. The political environment in which the broad controls are required to operate must be conducive to their use and, by the same token, acceptable to the many.

Political environment. Considerable Government action seems to be a certainty if we are to stabilize the economy at high levels of output, employment, and purchasing power. One step is to analyze the problem, another is to formulate a solution, but by far the most difficult step is putting the solution in action. Yet another difficulty presents itself. The solution must not only be accepted and understood by those affected, but it must be co-ordinated with other programs and must be consistent with the entire policy. The Government policy makers, therefore, must possess a large amount of economic understanding. The programs envisioned may have great impact on certain vested interests, as well as other governmental programs. The members of the legislative and executive branches of the Government owe their positions of power to the electorate. They will not support programs that they do not comprehend or that they feel will amount to political suicide. Thus, a problem of developing a high degree of sophistication among those who will be responsible for the passage and administration of the laws must be solved before a comprehensive, positive program can be put into effect. The voting

public, moreover, must be informed and satisfied with the economic policy. A politician can make the economic policy in effect look rather foolish to the naive public. The problem is acute, since many economists lack agreement on public economic policy. Some problems due to this lack of agreement have diminished as basic economic data have become available. The public, nevertheless, may not be aware that the lack of agreement may be only apparent and not real. The understanding of national economic problems has improved much in the past decade with the use of the national-income approach to economic analysis. Uniformity in approach to and solution of national economic problems is occurring, with the result that programs are becoming more effective and public acceptance more general.

Flexibility in Government programs. Any program upon which the Government embarks must be definite, thorough, and quickly put into effect. Little good can come from actions taken too late and partially thought out. Such criticism has been levelled at actions taken by the Federal Reserve Board regarding the supply of money and credit in the economy. Some writers feel that the Board acted to restrict credit too soon, while others feel its actions were tardy. We are faced with the age-old fact that the democratic process is slow, and that the National Government is so large that great difficulties arise in moving from policy decisions to action. A program of alleviating the undulations present in the economic system is much more effective if put into action immediately. Quick action may forestall a recession or choke off a dangerous inflation, whereas delay may require major repairs. The recession of late 1957 and 1958 may be a case in point. Government and business economists were aware of sagging activity in many sectors of the economy. But the Government found it difficult to formulate a program to combat it. The problem was complicated by the dilemma of a rising price level (inflation), with unemployment rising to almost 9 per cent of the work force. The solution and cure to this problem may still be forthcoming. The Government must be able to recognize moderate changes in the various sectors of the economy and move rapidly to forestall a major decline.

Tools of control. The government has a multitude of devices at its disposal to control and manipulate the entire economy. The direction of prices, employment, and productivity is sharply affected by Government actions, owing mainly to the size of the Government itself. The influences exerted upon the total economy are clearly indicated by the variations in the size of the gross national product, expenditures for personal consumption, net foreign investment, private domestic investment, and Government expenditures. Certain tools are

used to affect specific areas of the economy: for example, mortgage guarantees to encourage residential construction, or subsidies to airlines. Other devices, broad and general in scope, for example, fiscal and monetary policies and antitrust enforcement, tend to be felt throughout the economy.

Monetary and fiscal policies defined. Fiscal policy is concerned with the volume of Government tax receipts and expenditures, whereas monetary policy has to do with the volume of money and credit and under what terms they are available to borrowers and lenders. There is some disagreement as to which of these is most efficacious in stabilizing the economy. Monetary policy has been placed in a secondary role at times, but is unquestioned as a powerful device. The influence of each of these policies on our economy is discussed in the following paragraphs.

Monetary policy. Instruments of monetary policy usually fall into two groups: one is concerned with credit controls placed directly upon the consumer, while the other discourages or encourages lending institutions to grant loans.

Rediscount rate. Bank lending policies are directly affected by raising or lowering of the rediscount rate of the Federal Reserve Banks. Open-market operations of these institutions or changes in member bank reserve requirements ordered by the Federal Reserve Board of Governors may also have tremendous impact upon the money and credit supply in the economy. This, in turn, will affect business borrowing and the terms under which loans will be made. The Federal Reserve Act provides for the rediscounting of commercial paper by member banks with the Federal Reserve Banks. In this fashion, member banks are provided with funds to maintain their reserves and to loan additional amounts. The Federal Reserve Banks are essentially wholesalers of credit, but on their terms. They decide on the quality of the paper they will take and the interest they will charge to make the funds available. If credit needs expanding, the Reserve Banks may decrease the rediscount rate; if credit needs tightening, they may increase the rate. Traditionally, member banks have found it more desirable to sell their Government bonds to acquire needed additional funds than to discount their commercial paper. As a result, the rediscount rate has not been an effective weapon of monetary policy, at least in the recent past. The true impact of changes in the rediscount rate may be measured by its effect on the mental attitudes in the market place. Government policy in monetary matters is clearly indicated, however, by the moves made in the rediscount rate.

Open-market operations. Open-market operations have been used with greater consistency by the Federal Reserve Board, the redis-

count rate assuming second place. The Federal Reserve Banks have the ability to buy Government securities, creating funds in the form of cash or deposits in member banks. This, in turn, increases the reserves of member banks and thereby expands their ability to make loans. If the Federal Reserve Banks sell Government securities, the opposite result is obtained. The ability of the Federal Reserve Banks to enter the Government bond market is greatly facilitated by the fact that they may use the Government securities they purchase as a part of their legal reserves. The Government, through the Board of Governors of the Federal Reserve System, has a powerful device at its disposal for controlling the amount of credit in the economy. This power, however, is not without limitations, for in practice member banks have a great deal of influence in the affairs of the Federal Reserve Banks. Added to this, the Treasury Department is deeply involved with the management of the national debt, which impinges rather heavily on any large purchase or sale of Government securities.

Reserve requirements. The Federal Reserve Board is empowered with a third tool of monetary policy: member bank reserve requirements. Under present statutory limitations, legal reserves may range between 10 and 20 per cent of demand deposits. If the reserve requirements are raised, member banks will have fewer funds to lend, and a decrease will have the opposite effect. Control of reserve requirements is a powerful tool and is not used unless stern measures become necessary.

Credit restrictions. The fourth device employed in monetary control is selective credit restrictions. The Federal Reserve Board since 1934 has had the authority to set the amount of securities that may be purchased on credit. The Board from time to time has been given power to regulate the terms of consumer loans made by banks and small loan companies. Control of credit terms through the various Government agencies available to agriculture, small businesses, and other areas has affected the ability to borrow. Controls of this nature can discourage or encourage the flow of credit in the economy, with great effect.

Controls of the monetary variety lend themselves to holding down an inflation; they are generally not so effective in stunting a recession. Lending institutions may have large reserves, but borrowers may be nonexistent. In periods of contraction, businessmen are reluctant to expand; as sales fall, unused capacity appears and there is little need to borrow funds. On the other hand, banks may possess the reserves but be unwilling to loan them to anyone. Lowering down payments or easing margin requirements may not make investors or consumers move into the market. An easy credit environment is a prerequisite to stimulate buying and investing but it cannot do the job alone.

Fiscal policy. Fiscal policy may have profound effects upon the economy, even when the budget is in balance. An increase or decrease in Government expenditures may cause a rise or drop in employment in industries and areas affected. The effect is much greater if the Government spends more than it receives—the money supply is enlarged although production of consumer goods may not increase. Such a situation may continue for some time, so long as public confidence in the monetary system is not shaken. On the other hand, if tax receipts are greater than expenditures, a surplus of funds appears in the Government's cash budget and the supply of funds in private hands is decreased. Budget surpluses and deficits may have profound effects on the economy, much more so than movements in the area of Government spending. Assumptions regarding the spending habits of those taxed, however, must be made to arrive at definite conclusions.

There is present in the fiscal policy of the Federal Government "built-in," automatic stabilizers. The personal income tax, graduated as it is, takes less as income falls and more as incomes rise. Government spending programs tend to continue though revenues fall. An example of this may be seen in the budget deficit experienced in 1958—a surplus was predicted; a deficit was the case. Unemployment insurance, subsidy payments, and old-age insurance benefits act to stabilize consumption. They are, however, not powerful enough to do the job alone. Positive actions by the Government are usually necessary to lift the economy out of the doldrums. Tax cuts or increases in Government outlays may be necessary to overcome a recession. A decrease in the Federal income tax on the lower and middle income groups may immediately stimulate spending. Private investment may be encouraged by more liberal depreciation and depletion allowances, lower corporate taxes, or lower capital gains levies.

Most economists recognize the need for an integrated fiscal and monetary program to maintain growth and stabilize the economy. A friendly money market is a necessity for any program of deficits. The management of the Federal debt requires some co-ordination of the Federal Reserve System, member banks, and the Treasury Department. The mere fact that the commercial banks hold a large portion of the Federal debt and are able to sell their holdings to the Federal Reserve Banks, thereby increasing their ability to grant loans, gives us a prime example of the need for co-operative action by all parties concerned.

Influencing expenditures within the economy. In the realm of personal consumption, the portion of income available to consumers is sharply affected by changes in the income tax, subsidy payments in agriculture, social security payments, and unemployment benefits. A

change in the excise tax structure may have strong repercussions in the buying habits of many consumers. The changes of this type are usually of a long-run nature and do not serve well for short-run effects. The tool most quickly applied to effect expenditures is the direct control of consumer credit—the amount of the down payment and the length of time in which the contract must be paid out. This device has been most influential in controlling the sale of consumer durables. Investment in the economy involves business plant and equipment, residential building, and inventories. The tax program has been employed to influence this segment of the nation's economy. Accelerated depreciation, depletion allowances, and exemption of the profits of a new business have all been used to encourage investment in additional plant and equipment. Federal mortgage insurance terms—amount of the down payment, rate of interest to be paid, and length of time to repay principal—have been used to cause change in the residential construction sector of the economy.

Investment in inventories. Inventories have taken the attention of many business and Government economists in recent years. Investment in this sensitive sector has been considered crucial in at least one of the recessions in the past decade. Inventory fluctuations have been influenced mainly through monetary policy—availability of credit and defense contract prepayments. Little seems effective in this area, but a rising price level usually stimulates accumulation and a falling one has the opposite effect. A Government policy geared to the price level could have enormous effect in this sector.

Competitive climate of the economy. Finally, we may look at one other tool available for control of economic growth and stability: the competitive climate of the economy. Government expenditures on public works and monetary and fiscal policies of all types will be ineffective if there are obstacles to private investment and profit opportunities. A measure of freedom and happiness by which the American system has been characterized might be lost if the Government did not act to maintain a private competitive enterprise system in operation. Efficiency and vigor of such a system are not possible under a regulated economy. The intense rivalry in a freely competitive economy based upon individual reward leads to lower costs, lower prices, and greater efficiency. No authoritarian system can provide the flexibility in production and demand so desperately needed to keep the economy growing and vigorous. The objectives and problems of a planned economy are fantastic; centralized decision-making is a poor substitute, except in time of war, possibly, for the numerous consumers indicating their preferences in the market arena. Keeping the channels of the economy free of the impediments to private in-

vestment, industrial growth, and productivity is yet another tool in the Government's kit of economic aids.

Regulatory policy. In certain other areas the Federal and state governments can aid the growth of private free enterprise. The entire elimination or up-dating of regulations no longer needed may contribute greatly to the growth and stability of the economy. The immense field of peacetime uses of atomic energy may well reside in the hands of private business rather than government-owned projects. Tax laws leave much to be desired in creating a friendly climate for business investment. Provisions for accelerated amortization, elimination of state fair-trade and minimum price laws, broadened education, and ability to write off research and development expenses may aid and encourage industrial growth. The prevention of economic crises is needed if we are to preserve a large measure of individual freedom and private enterprise. It is extremely doubtful that the American people would tolerate another depression of the 1929 vintage without extreme Government intervention. The need for all those responsible, in both the Federal and the state governments, to employ all feasible devices within constitutional bounds to insure economic stability and growth is unquestioned. The dynamic qualities of a growing economy force us to recognize that we cannot entirely eliminate all fluctuations. Public policy, nevertheless, should consistently strive to hold these fluctuations within moderate limits to preserve long-range plans and goals. The confidence of the business world in the ability and soundness of Government policy will go a long way toward bolstering economic stability and growth.

One final note. The experiences of this country in public control in the past quarter-century lead us to conclude that once Government enters and regulates, it seldom abandons the function.[7] Little evidence of the past decade points in the opposite direction. If, however, public policy is successful and the economy attains a good measure of stability, it is not unreasonable to expect some withdrawal of Government regulation and intervention. The measurement of effects of Government policy is indeed difficult. If Government intervention increases cost without increasing productivity, wastes natural resources, and discourages capital formation, then injury has occurred. To evaluate results is most arduous, since numerous economic decisions are made by many groups other than governmental. Many examples of government control, that is, restricting output, increasing cost, and reducing price competition, are clearly evident in the statutes. Conversely, many government regulatory policies have

[7] John K. Galbraith, *American Capitalism* (Boston: Houghton Mifflin, 1952).

aided and encouraged the economic system to operate more efficiently. The more obvious examples are the insistence on fair dealing, the prohibiting of the waste of natural resources, and the limitations on monopoly power. Clearly, we have not subscribed to any one formula in solving our economic problems.[8] Our approach has been pragmatic. This may account for the apparent contradictions in our governmental policy over the years. An intelligent and informed voting population, however, can preserve individual liberty while providing an efficient and just economic organism.

Problem

To what extent do you think the Federal Government should regulate corporations, and why? In what areas would you suggest regulation?

[8] Further discussion may be found in Charles S. Hyneman, *Bureaucracy in a Democracy* (New York, Harper & Brothers, 1950).

Appendix A
Comparative Corporation and Tax Law Charts

State	1. Organization Tax Filing Fees and Miscellaneous Expenses	2. Inheritance Taxes on Transfer of Shares Held by Non-Resident
Delaware	(Based on authorized capital stock) Par Value Stock: 1¢ for each share of authorized capital stock having par value up to and including 20,000 shares, ½¢ for each such share in excess of 20,000 shares and up to and including 200,000 shares, and ⅕¢ for each such share in excess of 200,000 shares. Each $100 of par value is deemed one share for initial tax purposes. No-Par Value Stock: ½¢ for each share of authorized capital stock without par value up to and including 20,000 shares; ¼¢ for each such share in excess of 20,000 shares up to and including 2,000,000 shares, and ⅕¢ for each such share in excess of 2,000,000 shares. Minimum, $10. Recording-Indexing miscellaneous fees, approximately $25–30.	No tax
New Jersey	(Based on authorized capital stock) 20¢ per $1,000 of authorized stock having par value 1¢ per share for non-par value shares Minimum, $25. Filing fees and miscellaneous expenses, approximately $22.	No tax
New York	(Based on authorized capital stock) 1/20 of 1% of the par value. No-par value shares: 5¢ per share Minimum, $10. Filing fees, $40	No tax
Illinois	Initial license fee of 1/20 of 1% of the value expressed in dollars of the entire consideration received by the corporation for or on account of its issued shares reported to the secretary of state in its first report of issuance of shares. Issuing certificate of Incorporation, $20. Recording fees, $5 (estimated). Initial Franchise Tax—rate 1/12 of 1/20 of 1%, for each calendar month or fraction thereof, between date of issuance of shares reported to the Secretary of State in first report of issuance of shares, and the first day of July of the next succeeding calendar year of that proportion of the sum of its stated capital and surplus which the sum of (1) the value of its property located in Illinois and (2) the gross amount of business transacted at or from places of business in Illinois bears to the sum of (1) the value of all its property wherever located, and (2) the gross amount of its business wherever transacted. Minimum $10.	Shares owned by non-resident not taxed unless shares have acquired a business situs and decedent was a resident of state which does not come within Ill. reciprocal exemption statute

State	3. *Annual Franchise Tax*	4. *Stamp Tax on Transfer of Shares*
Delaware	The lesser of amounts determined under the two following methods: (1) Based on authorized shares (with or without par value) When 250 shares or less . . . . $ 5 50 Over 250 shares but not more than 1,000 shares . . . . 11.00 Over 1,000 shares but not more than 3,000 shares .... 22.00 Over 3,000 shares but not more than 5,000 shares . . .$27.50 Over 5,000 shares but not more than 10,000 shares 55 00 For each additional 10,000 shares or part thereof over 10,000 shares . 27 50 (2) Based on assumed no-par capital (assumed no-par capital = shares without par value × $100). To amount of tax thus ascertained under (2) add $110 for each $1,000,000 or fraction thereof in excess of $1,000,000 of the assumed par-value capital determined as follows: When assumed no-par value capital is $25,000 or less . . . . $ 5 50 When over $25,000 but not more than $100,000 .... 11 00 When over $100,000 but not more than $300,000 ... . 22.00 When over $300,000 but not more than $500,000 . $27 50 When over $500,000 but not more than $1,000,000 . .. . .. 55 00 For each $1,000,000 or part thereof .. ... 27.50 $\frac{\text{Total assets}}{\text{Total of all issued shares}}$ {If quotient of fraction is less than par value of any authorized par value shares, substitute par value for quotient, otherwise, use quotient.} × Authorized par value shares If assumed par value capital is less than $1,000,000, prorate tax on $110. Maximum, $50,000, minimum, $5.50 Inactive corporations pay ½ regular tax. Income Tax—The tax rate is 5% of taxable net income derived from business activities carried on within Delaware and from property located in Delaware. A corporation maintaining a statutory corporate office in the state but not doing business within Delaware is not subject to the tax.	None

New Jersey	Franchise Income tax measured by allocable net income at rate of 1¾% *plus* the greater amount of tax of: (a) that portion of its entire net worth as may be allocable to N. J.— *or* (b) that portion of its entire net worth as the average value of its total assets in N. J. is to the average value of its total assets everywhere— at 2 mills on first $100 million of taxable net worth; 4/10 on second $100 million; 3/10 on third $100 million; 2/10 on excess over $300 million. The tax assessed, notwithstanding above section, shall not be less than the greater of 5/10 of a mill per dollar of total assets to $100 million, or 2/10 of a mill on excess. Minimum tax, $25 for domestic corporations; $50 for foreign corporations.	None
New York	(A) Franchise tax measured by the greater of: (1) 5½% of its entire net income, or the portion thereof allocated to N. Y. (2) 5½% of an amount equal to 30% of the balance remaining after adding to entire net income compensation paid to officers and certain stockholders and deducting therefrom $15,000 (or a proportionate part thereof in the case of a report for less than a year) and any net loss for the reported year, or the portion of such amount allocated to N. Y. (3) 1 mill of the total of its business capital and investment capital, or the portion thereof allocated to N. Y. (4) Minimum, $25. (B) Real estate corporations are taxed ¼ of a mill on each dollar of full value of gross assets employed or situated in the state during the preceding calendar year, minimum tax being $10 plus 2% upon dividends and certain interest paid, to the extent to which such payments are attributable to N. Y.	2¢ per share where no sale involved. 1¢ per share sold at less than $5. 2¢ per share sold at $5–$9.99. 3¢ per share sold at $10–$19.99. 4¢ per share sold at $20 or over. Original issues not taxable.

Appendix A (cont.)

State	3. Annual Franchise Tax	4. Stamp Tax on Transfer of Shares
Illinois	Franchise Tax: Rate is 1/20 of 1% for the 12 month period commencing on the first day of July of that proportion of the sum of its stated capital and paid-in surplus which the sum of (1) the value of its property located in Illinois and (2) the gross amount of business transacted at or from places of business in Illinois bears to the sum of (1) the value of all its property, wherever located and (2) the gross amount of its business wherever transacted, except if the corporation in its annual report elects to pay its franchise tax upon the sum of its entire stated capital and paid-in surplus, such franchise tax shall be assessed accordingly until the corporation elects otherwise in a subsequent annual report. Minimum tax, $10.00. Capital stock tax: Rate varies with local property tax rate in district in which corporation has its principal office. Retail sales tax: 2½% of 98% of gross receipts.	None

State	5. *Incorporators* (1) Number (2) Residence (3) Qualifications (4) Place of meeting	6. *Stockholders* (1) Residence (2) Place of meeting (3) Maximum liability (4) Is cumulative voting permitted?	7. *Directors* (1) Number (2) Residence (3) Qualifications (4) Place of meeting	8. *Increase or Decrease in Number of Directors*	9. *Scope and Purpose Permitted Under One Charter*
Delaware	(1) 3 or more (2) No restrictions (3) Natural persons (4) Anywhere	(1) No restrictions (2) As charter or by-laws provide, within or without state (3) Unpaid portion of subscription (4) If provided for in charter	(1) 3 or more (2) No restrictions (3) As certificate of incorporation or by-laws provide (4) As by-laws provide, within or without the state	The by-laws provide for the number of directors. If provision is made in the charter giving directors power to amend by-laws, the directors can change the number.	Broad powers; any purpose or purposes except banking and public utilities to be operated within Delaware.

State	**5.** *Incorporators* (1) Number (2) Residence (3) Qualifications (4) Place of meeting	**6.** *Stockholders* (1) Residence (2) Place of meeting (3) Maximum liability (4) Is cumulative voting permitted?	**7.** *Directors* (1) Number (2) Residence (3) Qualifications (4) Place of meeting	**8.** *Increase or Decrease in Number of Directors*	**9.** *Scope and Purpose Permitted Under One Charter*
New Jersey	(1) 3 or more (2) No restrictions (3) Natural persons. Must be subscribers to the stock, not less than $1000 (4) No statutory provision. (Practice is to hold meetings in the State.)	(1) No restrictions (2) Within the state unless otherwise provided for in the certificate of incorporation or an amendment, or the by-laws (3) Unpaid portion of subscription (4) If provided for in charter	(1) 3 or more (2) No restrictions (3) Must be bona-fide stockholders or stockholders in corporation holding 25% or more of the stock (4) As charter or by-laws provide, within or without the state	The by-laws provide for the number of directors. If provision is made in the charter giving directors power to amend by-laws, the directors would then have power to change the number.	Fairly broad powers; any "lawful" purpose or purposes, except banking, building & loan, surety, insurance, and public service. Railroad, telephone, and telegraph companies operating outside the state are permitted to organize under the General Corporation Act.
New York	(1) 3 or more (2) One must be a resident of New York (3) Two-thirds must be citizens of the U. S.; all must be natural persons of full age and subscribers to the stock. (4) In New York	(1) No requirements (2) Within the state (3) Unpaid portion of subscription plus amounts due for wages, with limitations (4) If provided for in charter	(1) 3 or more (2) One must be a citizen of the U. S. and a resident of New York (3) Must be stockholders unless charter or by-laws otherwise provide (4) If only within state, charter or by-laws must so provide	The charter provides for the number of directors, and to increase or decrease that number an amendment must be filed.	Broad powers; any purpose or purposes except banking, insurance, railroad and transportation.

Appendix A (cont.)

State	5. *Incorporators* (1) Number (2) Residence (3) Qualifications (4) Place of meeting	6. *Stockholders* (1) Residence (2) Place of meeting (3) Maximum liability (4) Is cumulative voting permitted?	7. *Directors* (1) Number (2) Residence (3) Qualifications (4) Place of meeting	8. *Increase or Decrease in Number of Directors*	9. *Scope and Purpose Permitted Under One Charter*
Illinois	(1) 3 or more (2) No restrictions (3) Natural persons of full age and subscribers to the shares (4) Anywhere	(1) No requirements (2) Within or without the state as provided in by-laws. In absence of any by-law provision, shareholders' meetings must be held at registered office within state (3) Unpaid portion of subscription (4) Required by statute	(1) 3 or more (2) No restrictions (3) As articles of incorporation or by-laws provide (4) Within or without the state	The by-laws provide for the number of directors, number may be increased by amendment of by-laws; directors have power to make, alter, amend or repeal by-laws, unless reserved to the shareholders by the articles of incorporation	Any lawful purpose or purposes except for the purpose of banking or insurance or the operation of railroads. Railroads which have the major portion of their system within the metropolitan area of cities of at least 500,000 inhabitants are permitted.

State	10. Restrictions in Selecting a Corporate Name	11. (a) Duration (b) Limitation of Amount of Indebtedness	12. (1) Authorized Capital Stock (2) Classes of Stock	13. Par Value of Stock
Delaware	Must contain one of the following words: "association," "foundation," "company," "corporation," "club," "incorporated," "institute," "society," "union," "syndicate" or "limited" or abbreviations "Co.," "Inc.," "Ltd.," or words of like import in other languages. Use of word "trust" is prohibited except for corporations under supervision of State Bank Commissioner.	(a) Perpetual or limited (b) No statutory limitation	(1) Minimum, none Maximum, unlimited (2) Any number, with or without par	Par value of any amount No-par value shares permissible for all classes
New Jersey	Shall not contain words "insurance," "trust company," "trust," "bank," "banker," "banking," "safe deposit" or "title."	(a) Perpetual or limited (b) No statutory limitation	(1) Minimum, $2,000. Maximum, unlimited (2) Any number	Par value of any amount No-par value shares permissible for all classes
New York	Name must contain word or words, abbreviations, affix or prefix thereto as will clearly indicate it is a corporation.	(a) Perpetual or limited as provided in charter	(1) No restrictions as to amount	Par value of any amount

Appendix A (cont.)

State	**10.** *Restrictions in Selecting a Corporate Name*	**11.** (*a*) *Duration* (*b*) *Limitation of Amount of Indebtedness*	**12.** (*1*) *Authorized Capital Stock* (*2*) *Classes of Stock*	**13.** *Par Value of Stock*
New York	Shall contain none of following words: "trust," "bank," "banking," "banker," "bankers," "acceptance," "insurance," "assurance," "indemnity," "endowment," "guarantee," "guaranty," "title," "casualty," "surety," "fidelity," "finance," "bond," "bonding," "savings," "investment," "loan," "mortgage," "annuity," "annuities," "underwriter," "underwriters," "underwriting," or "benefit," except a moneyed corporation. Words "Masonry," "Mason," "Masons," "Masonic," "Free Masons," "Free and Accepted Masons," "Ancient Free and Accepted Masons," "Knights of Pythias," "Pythians," "Pythias," "Pythianism," or significant parts thereof may be used only with the consent of the Grand Lodge of Free and Accepted Masons of the State of New York. May not include "Doctor," "Dr." "Lawyer," "Engineers" or "Engineering." Must be in English letters or characters.	(b) No statutory limitation	(2) Any number	No-par value shares permissible for all classes
Illinois	Shall contain the word "corporation," "company," "incorporated," or "limited," or shall end with an abbreviation of one of said words.	(a) Perpetual or limited (b) No statutory limitation	(1) Minimum, $1,000 Maximum, unlimited (2) Any number, but each class is entitled to vote	Par value of any amount No-par value shares permissible for all classes

State	14. Commencement of Business		15. Payment of Capital		16. (a) Principal Office (b) Books and Records to Be Kept There	17. With Whom Filed
	Minimum to be Subscribed	Minimum to be Paid In	When	How		
Delaware	No requirements	$1,000	As provided for in the contract of subscription, or in absence of any provision, as called for by the directors	Money paid, labor done, or personal property, or real estate or leases thereof actually acquired	(a) Within the State (b) Duplicate or original stock ledger and transfer book	Secretary of State; also record certified copy with County Recorder of the county where principal office is located.
New Jersey	$1,000	$1,000	As provided for in the contract of subscription, or in absence of any provision, as called for or assessed by the directors	In money, property, or labor done	(a) Within the State (b) Stock ledger and transfer book	File and record first in office of Secretary of State; then record certified copy in County Clerk's office of county of principal office.
New York	No requirements	No requirements	As provided for in the contract of subscription, or in absence of any provision, as called for or assessed by the directors	In money, property, or labor done	(a) Within the State (b) Stock books and books of account	Secretary of State who will make, certify and transmit copy to county clerk of county where principal office is located for filing.
Illinois	$1,000	$1,000	As provided for in the contract of subscription, or in absence of any provision, as called for or assessed by the directors	In money, labor, property (tangible or intangible, except promissory notes) or services actually performed	(a) Within the State (b) Must keep record of its shareholders at principal place of business or registered office or at office of registrar or transfer agent in the state	Duplicate originals with Secretary of State. Record certificate of incorporation issued by Secretary of State with Recorder of Deeds of county where registered office is located.

Appendix B
Form of Mortgage

The form of mortgage varies somewhat in the several states. The form reproduced is the one used in New York, a lien theory state (see page 114).

Comments	*Mortgage*
Parties: If the maker of the mortgage is married and the right of dower exists, the wife must join in the mortgage. This is necessary to make the mortgage precede the dower right. A wife need not join in a purchase money mortgage since the mortgagee's claim is given priority over the wife's claim.	THIS MORTGAGE, made the ...... day of ...., nineteen hundred and ... . BETWEEN ...., the mortgagor, and ...., the mortgagee.
The amount of the mortgage, interest rate, and due date. Notice reference to the bond. The description of the mortgaged property, just as it appears in the deed, would be filled in after the word "mortgagee."	WITNESSETH, that to secure the payment of an indebtedness in the sum of ...... dollars, lawful money of the United States, to be paid on the ...... day of ...., nineteen hundred and ...., with interest thereon to be computed from ...., at the rate of ...... per centum per annum, and to be paid .... according to a certain bond or obligation bearing even date herewith, the mortgagor hereby mortgages to the mortgagee, ...
Important in certain types of property.	Together with all fixtures and articles of personal property, now or hereafter attached to, or used in connection with the premises, all of which are covered by this mortgage.
Covenants (provisions which set forth the rights and obligations of the parties):	And the Mortgagor covenants with the Mortgagee as follows:
1. To pay the indebtedness.	1. That the mortgagor will pay the indebtedness as hereinbefore provided.

2. To insure the property. This gives the mortgagee the right to use the insurance proceeds to reduce the amount of his claim.	2. That the mortgagor will keep the buildings on the premises insured against loss by fire for the benefit of the mortgagee; that he will assign and deliver the policies to the mortgagee; and that he will reimburse the mortgagee for any premiums paid for insurance made by the mortgagee on the mortgagor's default in so insuring the buildings or in so assigning and delivering the policies.
3. Not to remove or demolish without the consent of the mortgagee, and thereby lower the value of the security.	3. That no building on the premises shall be removed or demolished without the consent of the mortgagee.
4. Acceleration of maturity on default in payment of installment of principal, interest, taxes, in turning over insurance policy, or reimbursing mortgagee for premium, or in furnishing requested estoppel certificate (see clause 7).	4. That the whole of said principal sum and interest shall become due at the option of the mortgagee: after default in the payment of any instalment of principal or of interest for .... days; or after default in the payment of any tax, water rate or assessment for ...... days after notice and demand; or after default after notice and demand either in assigning and delivering the policies insuring the buildings against loss by fire or in reimbursing the mortgagee for premiums paid on such insurance, as hereinbefore provided; or after default upon request in furnishing a statement of the amount due on the mortgage and whether any offsets or defenses exist against the mortgage debt, as hereinafter provided.
5. Receiver clause.	5. That the holder of this mortgage, in any action to foreclose it, shall be entitled to the appointment of a receiver.
6. To pay taxes, assessments, and water rates.	6. That the mortgagor will pay all taxes, assessments, or water rates, and in default thereof, the mortgagee may pay the same.
7. To furnish mortgagee with estoppel certificate on request if the mortgagee wishes to sell the mortgage. The mortgagee cannot later refute this statement as to the status of the mortgage.	7. That the mortgagor within .... days upon request in person or within .... days upon request by mail will furnish a written statement duly acknowledged of the amount due on this mortgage and whether any offsets or written defenses exist against the mortgage debt.

Appendix B (cont.)

Comments	*Mortgage*
8. Manner of giving notice. If this were not present, personal notice would be required.	8. That notice and demand or request may be in writing and may be served in person or by mail.
9. Warranty of title; guarantees that mortgagor has good title.	9. That the mortgagor warrants the title to the premises.
10. Acceleration of maturity on default in payment of assessments for improvements.	10. That the whole of said principal sum shall become due at the option of the mortgagee after default for 60 days after notice and demand, in the payment of any instalment of any assessment for local improvements heretofore or hereafter laid, which is or may become payable in annual instalments and which has affected, now affects or hereafter may affect the said premises, notwithstanding that such instalment be not due and payable at the time of such notice and demand.
11. Acceleration of maturity upon default in upkeep; obligates the owner to maintain the property. Mortgagee can also step in and do what is necessary to prevent municipality from making building tenantless (thus impairing the value of the lien) or doing the work itself.	11. That the whole of said principal sum shall become due at the option of the mortgagee, if the buildings on said premises are not maintained in reasonably good repair or upon the failure of any owner of said premises to comply with the requirement of any department of the State or City of New York, within three months after an order making such requirement has been issued by any said State or City Department.
12. So-called Brundage clause, inserted to permit mortgagee to raise the rate of interest equal in amount to any taxes that state may impose on the mortgagee in respect to the mortgage. Mortgagee has option of calling in the mortgage.	12. In the event of the passage after the date of this mortgage of any law of the State of New York, deducting from the value of land for the purposes of taxation any lien thereon, or changing in any way the laws for the taxation of mortgages or debts secured by mortgage for state or local purposes, or the manner of the collection of any such taxes, so as to affect this mortgage, the holder of this mortgage and of the debt which it secures, ... shall have the right to give 30 days' written notice to the owner of the mortgaged

premises requiring the payment of the mortgage debt. If such notice be given the said debt shall become due, payable, and collectible at the expiration of said 30 days.

13. Sale in one parcel clause; needed only in mortgage that covers more than one lot.	13. That in case of a sale, said premises, or so much thereof as may be affected by this mortgage, may be sold in one parcel.
14. Acceleration of maturity on assignment of rents without consent of mortgagee, or on threat of demolition.	14. That the whole of said principal sum shall immediately become due at the option of the mortgagee if the mortgagor shall assign the rents or any part of the rents of the mortgaged premises without first obtaining the written consent of the mortgagee to such assignment, or upon the actual or threatened demolition or removal of any building erected or to be erected upon said premises.
15. Acceleration of maturity on failure to insure or on inability to obtain insurance; amplifies clause 2.	15. That the whole of said principal sum shall immediately become due at the option of the mortgagee upon any default in keeping the buildings on said premises insured against loss by fire as required by paragraph No. 2 above, or if after application by any holder of this mortgage to two or more fire insurance companies lawfully doing business in the State of New York and issuing policies of fire insurance upon buildings situate in the place where the mortgaged premises are situate, the companies to which such application has been made shall refuse to issue such policies.
16. Assignment of rents upon default or foreclosure; should be read in connection with clause 14.	16. That the holder of this mortgage in any action to foreclose it, shall be entitled (without notice and without regard to the adequacy of any security for the debt) to the appointment of a receiver of the rents and profits of said premises; and in the event of any default in paying said principal or interest, such rents and profits are hereby assigned to the holder of this mortgage as further security for the payment of said indebtedness.
17. Obligates owner to use funds received on the mortgage loan to pay for work done on the property before he diverts such funds to any other use.	17. That if any improvements, repairs, or alterations have been commenced and have not been completed at least four months before the making of this loan, the mortgagor will receive the advances secured by this mortgage and will

Appendix B (cont.)

Comments	*Mortgage*
	hold the right to receive such advances as a trust fund to be applied first for the purpose of paying the cost of improvement, and that he will apply the same first to the payment of the cost of improvement before using any part of the total of the same for any other purpose.
18. Owner-rent clause. Makes a specific contract whereby the owner, in the event of a default and the appointment of a receiver, agrees to pay a fair rent to the receiver. Without this clause the owner-mortgagor might have the right to occupy the premises rent-free after default.	18. That the holder of this mortgage (or if the same be extended), in addition to the rights reserved aforementioned as if the same were specifically set forth, shall also be entitled to the appointment of a receiver of the rents and profits of said premises, in the event that the mortgagor or any subsequent owner of said premises is in possession of the whole or any part of the within described premises, for the express purpose of collecting the reasonable rental or occupational value of said premises. And said owner hereby agrees to pay the reasonable rental of said premises to the Receiver so appointed.
19. Changes in instrument to be in writing.	19. This instrument may not be altered or varied except in writing.

IN WITNESS WHEREOF, the mortgage has been duly executed by the mortgagor.

In presence of: .... L. S.

IN WITNESS WHEREOF, the mortgage has been duly executed by the mortgagor.

In presence of: .... L. S.

(Acknowledgment)

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